

*Assisting School District Employees With Gaining Direct Access To No-Load, Low-Expense 403(b) Plan Accounts*

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**I. Introduction**

In "Reasons for and Responses to the Lack of Direct Access to No-Load, Low-Expense 403(b) Plans in Many School Districts", published in the Fall 2006 *PIABA Bar Journal*<sup>1</sup> I stated that many school districts only give 403(b) plan participant employees the option to invest in high-cost variable annuities or high-cost load mutual funds. As a result, the tax advantages gained by 403(b) plan investors are being eradicated by high investment costs in school districts that deny their employees direct access to no-load, low-expense 403(b) plan accounts. I concluded that attorneys will remain busy representing school district employees in their quest to gain direct access to no-load, low-expense 403(b) plan accounts.

After that article was published, I received inquiries from several attorneys asking how they may be able to use their skills to help school district employees gain access to no-load, low-expense 403(b) plan accounts. Therefore, in this article, I will describe four potential legal actions and one potential nonlegal action that attorneys may recommend in an effort to assist school district employees with gaining direct access to no-load, low-expense 403(b) plan accounts.

The four potential legal actions are: (1) bringing an action under ERISA against the school district for breach of fiduciary duty if the school district exercises any discretion over or pertaining to the 403(b) plan and the 403(b) plan is not a governmental plan; (2) bringing an action under state law against the school district for breach of fiduciary duty if adequate state law exists; (3) bringing a class action lawsuit against unions endorsing high-expense 403(b) plan contracts and against high-expense 403(b) plan contract providers endorsed by unions; and, (4) bringing an action against a financial services firm and/or registered representative for selling an unsuitable variable annuity to an employee within the employee's 403(b) plan account.

The potential nonlegal action is recommending that school district employees form a committee and lobby the school district to make available a no-load, low-expense 403(b) plan account.

In addition, the article describes why the modification of Revenue Rule 90-24 by new regulations will likely result in even more school district employees seeking the advice of

<sup>1</sup> Engdahl, Michael B., "Reasons For and Responses to the Lack of Direct Access to No-Load, Low-Expense 403(b) Plans in Many School Districts," *PIABA Bar Journal*, Fall 2006, pp. 35-47 <[http://www.403bwise.com/pdf/engdahl\\_403b\\_schools.pdf](http://www.403bwise.com/pdf/engdahl_403b_schools.pdf)>.

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attorneys regarding how they may gain direct access to no-load, low-expense 403(b) plan accounts.

## **II. The New Regulations' Modification of Revenue Rule 90-24**

In my first article, I stated that many employees, who were denied direct access to no-load, low-expense 403(b) plan accounts, have taken advantage of I.R.S. Revenue Rule 90-24 in order to gain *indirect* access to no-load, low-expense 403(b) plan accounts. Under this rule, if an employee transfers funds from one 403(b) account to another, and the transferred funds continue to be subject to the early distribution restrictions as set forth in the Internal Revenue Code, the transfer is not an actual distribution and, consequently, is not a taxable transfer.<sup>2</sup> In essence, Revenue Rule 90-24 has allowed an employee to gain indirect access to a no-load, low-expense 403(b) plan account even when her employer refused to remit a portion of her pay directly to a no-load, low-expense 403(b) plan account.

To effectively facilitate a 90-24 transfer and avoid sales and surrender charges, an employee would typically take the following five steps:

1. From the school district's list of approved 403(b) vendors, the employee would find a vendor that offers a no-load money market mutual fund within its 403(b) plan account. (Many money market funds, even if offered by high-expense mutual fund or insurance companies, do not impose any sales or surrender charges.)
2. The employee would then open up a 403(b) plan account with the approved 403(b) plan vendor offering the no-load money market fund as an investment option (Account #1).

2. Next, the employee would open up a 403(b) plan account with a no-load, low-expense mutual fund or insurance company (Account #2).

3. The employee would then instruct his employer to remit his 403(b) plan contributions to Account #1.

5. Next, periodically (e.g., every month, quarter, etc.), the employee would mail necessary paperwork to facilitate a 90-24 transfer from the money market fund in Account #1 to Account #2.

On July 26, 2007, the Internal Revenue Service issued extensive new regulations under Internal Revenue Code Section 403(b). The new regulations substantially restrict 90-24 transfers by invalidating 403(b) contract transfers by current employees when the 403(b) contract transferred to is not held under the employer's written 403(b) plan<sup>3</sup>. In other words, non-taxable transfers to 403(b) plan account providers that have no contractual relationship with the school district's 403(b) plan are no longer allowed while the employee is employed by the school district. The effect of the new regulations is the closing of an escape hatch that has allowed many 403(b) plan investors to cost-effectively transfer from a high-expense 403(b) plan account to a no-load, low-expense 403(b) plan account. This modification of Revenue Rule 90-24 will likely result in an increase in 403(b) plan participants seeking the assistance of attorneys in an effort to gain direct access to no-load, low-expense 403(b) plan accounts.

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<sup>2</sup> Internal Revenue Service Revenue Rule 90-24, p. 3 <<http://taxlinks.com/rulings/1990/revrul90-24.htm>>.

<sup>3</sup> See Section 1.403(b)-10(b) of the final regulations <[http://www.irs.gov/pub/irs\\_tege/td9340.pdf](http://www.irs.gov/pub/irs_tege/td9340.pdf)>.

**III. Potential Legal Action # 1: Bring an Action Under ERISA Against the School District for Breach of Fiduciary Duty if the School District Exercises Any Discretion Over or Pertaining to the 403(b) Plan and the 403(b) Plan is Not a Governmental Plan**

According to ERISA Section 3(21)(A), an employer is a fiduciary with respect to a retirement plan and, thus, is subject to ERISA fiduciary duties “to the extent” that the employer “exercises any discretionary authority or discretionary control respecting management” of the plan or “has any discretionary responsibility in the administration of the plan.” Correspondingly, one of these ERISA fiduciary duties should be to ensure that the retirement plan includes quality, diversified, low-expense investment options.

However, bringing an action under ERISA against a school district for breach of fiduciary duty has often proved difficult, for two main reasons.

A. 403(b) plans are individual plans in which the school district typically merely arranges for an employee to invest through payroll deductions into a plan chosen by the employee. Therefore, as to many 403(b) plans, the employer acts as a *mere conduit* and thus fails to satisfy the control test under ERISA Section 3(21)(A). Moreover, Department of Labor regulations state that an employer offering a 403(b) plan program may be exempt from ERISA if:

1. Participation is completely voluntary for employees;

2. All rights under the annuity contract or custodial account are enforceable solely by the employee, by a beneficiary of such employee, or by any authorized representative of such employee or beneficiary;

3. The employer does nothing more than make information about the plan available to its employees; and

4. The employer receives no consideration or compensation for permitting employees to participate in the plan other than, at most, reimbursement for expenses incurred in implementing salary reduction agreements.<sup>4</sup>

However, it is important to note that if the school district makes discretionary decisions in administering the 403(b) plan program (e.g., makes employer contributions, specifically selects investment providers, etc.), the school district may satisfy the control test under ERISA Section 3(21)(A) and thus owe ERISA fiduciary duties.

B. ERISA Section 4(b)(1) exempts from ERISA regulation “any employee benefit plan if such plan is a governmental plan (as defined in Section 3(32)).”<sup>5</sup> Therefore, bringing an action under ERISA against a school district for breach of fiduciary duty is typically not advisable if the school district is a public school district or if the school district does not exercise any discretion over or pertaining to the 403(b) plan. However, bringing an action under ERISA against a school district for breach of fiduciary duty may be a possibility if the school district is a private non-governmental school district and the school district makes discretionary decisions in administering the 403(b) plan program.

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<sup>4</sup> See 29 CFR Section 2510.3-2(f). Also, see FAB 2007-2.

<sup>5</sup> ERISA Section 3(32) states that “a ‘governmental plan’ means a plan maintained for its employees by the Government of the United States, by the government of any State or political subdivisions thereof, or by any agency or instrumentality of any of the foregoing.”

**IV. Potential Legal Action #2: Bring an Action Under State Law Against the School District for Breach of Fiduciary Duty if Adequate State Law Exists**

Just because some school districts may be exempt from ERISA fiduciary duties (if they fail to satisfy the control test under ERISA Section 3(21)(A) or are a governmental employer), they may not be exempt from fiduciary governance over the 403(b) plans they make available to their employees. Many school districts are subject to state fiduciary laws, which are based on principles similar to those underlying ERISA (e.g., the prudent man rule, the duty of loyalty, the exclusive purpose rule, prohibited transaction restrictions, etc.).<sup>6</sup> A number of state statutes use language that is virtually identical to the fiduciary duties described in ERISA. For example, California has specific fiduciary rules applicable to public school plans under the California Education Code.<sup>7</sup> Section 22250 of the Education Code has the same wording of ERISA Section 404(a) and provides:

The board and its officers and employees of the system shall discharge their duties with respect to the system and the plan solely in the interest of the members and beneficiaries of the Defined Benefit Program as well as the participants and beneficiaries of the Cash Balance Benefit Program as follows:

(a) For the exclusive purpose of the following:

(1) Providing benefits to members and beneficiaries of the Defined Benefit Program as well as the participants and beneficiaries of the Cash Balance Benefit Program.

(2) Defraying reasonable expenses of administering the plan.

(b) With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an enterprise of a like character and with like aims.

(c) By diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.

(d) In accordance with the documents and instruments governing the plan and the system insofar as those documents and instruments are consistent with this part and Part 14 (commencing with Section 26000).<sup>8</sup>

Perhaps the biggest challenge with bringing an action under state law against a school district for breach of fiduciary duty is finding relevant state law. Not all states have been as proactive as California in enacting statutes that define the fiduciary duties that school districts owe to retirement plan participant employees. Furthermore, even if a state has enacted such laws, they may define fiduciary duties that school districts owe to participant employees of only certain types of retirement plans. For example, a careful reading of California Education Code 22250 indicates that the section is intended to describe the fiduciary duties that school districts owe to “members and beneficiaries of the Defined Benefit Program” and “participants and beneficiaries of the Cash Balance Benefit Program.” However, the code section is silent as to the fiduciary duties that school districts owe to 403(b) plan participant employees.

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<sup>6</sup> Reish, Fred and Bruce Ashton, “Fiduciary Rules Applicable to ‘(b)’ Plans,” Reish, Luftman, Reichter & Cohen, January 2005, p. 2 <[http://www.reish.com/publications/article\\_detail.cfm?ARTICLEID=532](http://www.reish.com/publications/article_detail.cfm?ARTICLEID=532)>.

<sup>7</sup> Id.

<sup>8</sup> California Education Code Section 22250 <<http://caselaw.lp.findlaw.com/cacodes/edc/22250-22261.html>>.

**V. Potential Legal Action #3: Bring a Class Action Lawsuit Against Unions Endorsing High-Expense 403(b) Plan Contracts and Against High-Expense 403(b) Plan Contract Providers Endorsed by Unions**

Some of the nation's largest teachers unions have joined forces with financial services companies to steer members into high-expense 403(b) plan contracts.<sup>9</sup> Teachers unions currently endorse financial services firms, 403(b) plan contracts and financial products. In return, the financial services firms reciprocate with financial support for the unions.<sup>10</sup> For example, the National Education Association (NEA) collected nearly \$50 million in royalties in 2004 on the sale of annuities, life insurance and other financial products.<sup>11</sup> In addition, the New York State United Teachers (NYSUT) has received as much as \$3 million a year from ING Group for encouraging its 525,000 members to invest in an annuity sold by the insurance company.<sup>12</sup>

The relationship between NYSUT and ING prompted an investigation by the New York State Attorney General's Office. The investigation revealed that a 403(b) plan, offered by ING and endorsed by NYSUT's Member Benefits unit, charged investors fees and expenses as high as 2.85% per year

while delivering only limited benefits.<sup>13</sup> The investigation also revealed that NYSUT's Member Benefits Unit endorsed ING's 403(b) plan even though less expensive alternatives were available, received undisclosed payments of as much as \$3 million per year for endorsing ING's 403(b) plan and took steps to conceal its financial arrangement with ING from its members.<sup>14</sup>

In June 2006, NYSUT's Member Benefits Unit entered into an agreement with the New York Attorney General's Office to resolve the investigation.<sup>15</sup> Under the agreement, the unit promised to adopt a series of reforms and pay \$100,000 to cover the costs of the investigation.<sup>16</sup>

In addition, in October 2006, the Attorney General's investigation of ING Group ended with ING agreeing to pay \$30 million as restitution directly to NYSUT members who participated in the ING 403(b) plan.<sup>17</sup> ING also agreed to more fully disclose plan information by providing a summary of the costs of each plan it offers.

In March 2007, a class-action suit was filed on behalf of NYSUT members against NYSUT, NYSUT Member Benefits Trust and ING in the United States District Court for the Southern District of New York for violations of

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<sup>9</sup> Kristoff, Kathy M., "Unions' Advice is Failing Teachers." *latimes.com*, April 25, 2006, p. 1 <<http://latimes.com/business/la-fi-retire25apr25,0,6936648,print.story?coll=la-home-bu> . . . >.

<sup>10</sup> Id.

<sup>11</sup> Id., p. 2.

<sup>12</sup> Id., p. 2.

<sup>13</sup> New York State Attorney General, "NYSUT's Members Benefits Unit Settles Probe: Settlement is Part of Ongoing Investigation of Retirement Products," p. 1 <[http://www.oag.state.ny.us/press/2006/jun/jun13b\\_06.html](http://www.oag.state.ny.us/press/2006/jun/jun13b_06.html)>.

<sup>14</sup> Id.

<sup>15</sup> Id.

<sup>16</sup> Id.

<sup>17</sup> New York State Attorney General, "Insurance Giant Agrees to Sweeping Reforms: ING to Compensate Upstate Teachers After Probe Reveals Hidden Influence over Union," p. 1 <[http://www.oag.state.ny.us/press/2006/oct/oct10a\\_06.html](http://www.oag.state.ny.us/press/2006/oct/oct10a_06.html)>.

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ERISA.<sup>18</sup> In their complaint, plaintiffs state that NYSUT and NYSUT Member Benefits Trust are subject to fiduciary duties under ERISA with respect to the 403(b) plan they endorsed for the following reason:

As with any retirement plan, a section 403(b) plan is considered an “employee pension benefit plan” as that term is defined by ERISA, and, thus, subject to ERISA, if it is established or maintained by an employer or **employee organization**. ERISA Section 3(2)(A), 29 U.S.C. Section 1002(2)(A). NYSUT and NYSUT Trust, **employee organizations**, through their extensive involvement in the set-up, management, and administration of the Plan, established and maintained the Plan.<sup>19</sup>

In July 2007, a new class-action lawsuit was filed on behalf of NEA members against NEA, NEA Member Benefits Corporation, Nationwide Life Insurance Company, and Security Benefit Corp. in the United States District Court Western District of Washington at Tacoma.<sup>20</sup> The complaint is similar to the one filed against NYSUT, NYSUT Member Benefits Trust and ING and alleges that hefty payments made from Nationwide and Security Benefit to NEA Member Benefits were not disclosed to NEA plan participants.<sup>21</sup> Moreover, an attorney for the plaintiffs explained why plaintiffs feel their 403(b) plans are governed by ERISA in the following way:

The ERISA exemption applies to situations where the employer does

nothing more than arrange for salary deferral for its employees. But in endorsed plans, the union together with the insurance company are taking over the role that the plan sponsor plays.<sup>22</sup>

Only time will tell if the plaintiffs will overcome the challenges necessary to prevail in the aforementioned class-action suits. The greatest challenge is likely to be proving that the defendants are subject to ERISA fiduciary duties.

**VI. Potential Legal Action #4: Bring an Action Against a Financial Services Firm and/or Registered Representative for Selling an Unsuitable Variable Annuity to an Employee Within the Employee’s 403(b) Plan Account**

In 1999, the NASD issued Notice to Members 99-35 in order to remind NASD members of their responsibilities pertaining to variable annuity sales within tax-deferred accounts, such as 403(b) plan accounts. The notice states:

When a registered representative recommends the purchase of a variable annuity for any tax-qualified retirement account . . . the registered representative should disclose to the customer that the tax-deferral account feature is provided by the tax-qualified retirement plan and that the tax-deferred account feature of the variable annuity is unnecessary. The registered representative should recommend a variable annuity only when

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<sup>18</sup> See *Montoya v. ING* complaint at <[http://www.erisaclassactionwatch.com/wp-content/uploads/2007/04/montoya\\_v\\_ing\\_complaint.pdf](http://www.erisaclassactionwatch.com/wp-content/uploads/2007/04/montoya_v_ing_complaint.pdf)>.

<sup>19</sup> *Id.*, pp. 1-2.

<sup>20</sup> See *Daniels-Hall v. NEA* complaint at <[http://www.erisaclassactionwatch.com/wp-content/uploads/2007/07/daniels-hall\\_v\\_nea.pdf](http://www.erisaclassactionwatch.com/wp-content/uploads/2007/07/daniels-hall_v_nea.pdf)>.

<sup>21</sup> Morgenson, Gretchen, “Lawsuit Says Teachers Are Overcharged on Annuities.” *nytimes.com*, July 17, 2007, p. 1 <[http://www.nytimes.com/2007/07/17/business/17suit.html?\\_r=1&oref=slogin&pagewanted...](http://www.nytimes.com/2007/07/17/business/17suit.html?_r=1&oref=slogin&pagewanted...)>.

<sup>22</sup> *Id.*, p. 2.

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its other benefits, such as lifetime income payments, family protection through the death benefits and guaranteed fees support the recommendation.<sup>23</sup>

The Notice further states that an NASD member “should conduct an especially comprehensive suitability analysis prior to approving the sale of variable annuities with surrender charges in a tax-qualified plan subject to minimum distribution requirements.”<sup>24</sup> In 403(b) plans, minimum distributions are required to begin by April 1 of the year after the account owner turns age 70 ½.<sup>25</sup>

The result of NTM 99-35 has been a flood of class action lawsuits filed by investors who were sold variable annuities within their tax-deferred accounts against insurance companies whose agents recommended the purchase of the annuities. Most of the claims allege that the insurance companies did not honor the guidelines set forth in the notice, and some of the claims have resulted in substantial settlements.<sup>26</sup> For example, American Express agreed to pay more than \$215 million in benefits to more than two-million class participants.<sup>27</sup>

The lawsuits appear to be aimed only at insurance companies that sell high-expense, agent sold annuities in tax-deferred accounts and are not aimed at insurers, like TIAA-CREF, that offer no-load, no surrender charge, low-expense variable annuities in tax-

deferred accounts. Most of the suits ask for insurers to repay “superfluous” insurance fees and refund surrender charges on improperly sold policies.<sup>28</sup> The suits also seek to stop “deceptive” sales practices by the insurance companies.<sup>29</sup>

It is likely that attorneys will remain busy filing actions against financial services firms and registered representatives for selling unsuitable variable annuities to employees within the employees’ 403(b) plan account. This is because many registered representatives continue to sell variable annuities within 403(b) plan accounts even though mutual funds, which often carry less overall expenses than annuities, are allowable investments within 403(b) plan accounts. According to the Spectrem Group, a Chicago-based research firm, of the approximately \$600 million invested in 403(b) plans at the end of year 2005, almost \$500 million was invested in annuities.<sup>30</sup>

**VII. Potential Nonlegal Action:  
Recommend that School District  
Employees Form a Committee and Lobby  
the School District to Make Available a No-  
Load, Low-Expense 403(b) Plan Account**

Employees can form a committee within their school district and ask the school district to include in its 403(b) plan options a no-load, low-expense 403(b) plan account. When petitioning the school district, the committee should provide the school district with

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<sup>23</sup> NASD Notice to Members 99-35, p. 3 <[http://www.nasd.com/web/groups/rules\\_regs/documents/notice\\_to\\_members/nasdw\\_004395.pdf](http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_004395.pdf)>.

<sup>24</sup> Id.

<sup>25</sup> I.R.S. Publication 571, p. 14 <<http://www.irs.gov/pub/irs-pdf/p571.pdf>>.

<sup>26</sup> Panko, Ron, “Can Annuities Pass Muster?” *Best’s Review*, July 2000, p. 106.

<sup>27</sup> Id.

<sup>28</sup> “What a Deal: A Lawyer is Suing to Prove the Obvious; that Variable Annuities in Qualified Plans are Not a Bargain,” *Dow Jones Investment Advisor*, December 1999, p. 20.

<sup>29</sup> Id.

<sup>30</sup> Wasik, John F., “New Jersey Teacher Wins Fight on Retirement Fees.” *Bloomberg.com*, October 2, 2006, p. 1 <<http://www.bloomberg.com/apps/news?pid=20601039&sid=aQm8SUAzWPHk&refer=home>>.

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information about recent claims filed against school districts, unions, financial services firms and registered representatives involving high-expense 403(b) plan contracts and accounts.<sup>31</sup> The committee should provide the school district with research illustrating the long-term detrimental effect of high fees and expenses on investments.<sup>32</sup> It should also point out the potential benefits to the school district for allowing its employees direct access to no-load, low-expense 403(b) plan accounts.

One such benefit to the school district that the committee should mention is that if a no-load, low expense 403(b) plan account is made available, each employee's future 403(b) account balance may be substantially greater than if the employees were forced to invest in high-cost investments. The committee should explain that a higher account balance would be beneficial to the school district because employees may be able to retire sooner. For example, assume that because a teacher periodically invests in a no-load, low-expense mutual fund or variable annuity within her 403(b) plan account, her 403(b) plan account balance at age 60 is \$200,000 more than it would have been if she was forced to invest in high-cost investments.<sup>33</sup> Also, assume that because her 403(b) account is \$200,000 larger, the teacher decides to retire at age 60 as opposed to age 63.

This would result in over \$100,000 in cost savings to the school district if the retired teacher was making \$70,000 per year at age 60 and the school district replaced her with a new teacher to whom they paid only \$35,000 per year.

The committee should explain to the school district that providing employees with direct access to no-load, low-expense 403(b) plan accounts may assist the school district with attracting and retaining employees. Many school districts in the country facing teaching shortages may find this argument particularly persuasive.

### **VIII. Conclusion**

One can only hope that school districts and teachers unions will take a more proactive stance in ensuring that employees have direct access to no-load, low-expense 403(b) plan accounts. This would be of great benefit to *both* school district employees and school districts. However, until this stance is taken, attorneys should remain busy assisting school district employees with gaining direct access to no-load, low-expense 403(b) plan accounts.

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<sup>31</sup> An excellent place to find information about recent claims filed involving 403(b) plans is on the website [www.403bwise.com](http://www.403bwise.com).

<sup>32</sup> To view an example of how to show the effect of fees on investment performance over time, see Engdahl, pp. 40-41.

<sup>33</sup> *Id.*