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TOPIC: 401(k) Fiduciary Litigation: Morals from the Story

MARKET TREND: The uptick in litigation challenging 401(k) plan investments, investment fees, and vendor expenses continues. Court decisions in these cases can provide lessons for ERISA fiduciaries to follow to reduce the risk of these claims.

SYNOPSIS: 401(k) plans and plan sponsors continue to see lawsuits alleging various breaches of ERISA fiduciary duties. These lawsuits generally allege one or more of the following ERISA fiduciary breaches: (i) that plan investments have significantly underperformed, (ii) that plan investment fund expenses are excessive, (iii) that plan recordkeeping or other vendor fees are excessive, or (iv) that parties to the plan have engaged in some form of improper self-dealing. While many of the lawsuits are against large 401(k) plans, smaller plans are not immune. In this article, we review some of the key types of plan features and conduct that can trigger these lawsuits. We also explore several key cases from recent years that help define the risk of exposure to these lawsuits, and that, like an Aesop Fable, may suggest morals to live by for ERISA fiduciaries.

TAKEAWAYS: Plan sponsors and administrators should review their 401(k) plans in light of this litigation trend, and, at a minimum, be aware of plan features that might give rise to claims. By looking at the types of claims being made and the holding in several key cases, employers can derive best practices to follow that can reduce exposure to claims and improve defenses if claims are made.

ERISA FIDUCIARY DUTIES: A QUICK REMINDER

The Employee Retirement Income Security Act of 1974 ("ERISA") identifies certain individuals as "fiduciaries." These fiduciaries include "named fiduciaries"—such as the plan administrator and trustee—as well as other individuals who exercise discretionary authority over plan assets or administration or who provide investment advice for a fee.

ERISA fiduciaries must meet both a duty of care and a duty of loyalty. Courts like to say that ERISA fiduciary duties are the highest duties known to law.

The duty of care focuses on a duty to act prudently. To meet the ERISA prudence standard, the fiduciary must perform "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use. . . ."[1] The duty of care does not require that every decision be correct in hindsight. To meet this duty, however, ERISA fiduciaries must make informed decisions following a reasonable, documented process.

The duty of loyalty requires that ERISA fiduciaries act for the exclusive benefit of plan participants and beneficiaries. As a result, various forms of self-dealing are prohibited. Having a good process or good intentions often provides no defense to claims of breach of the duty of loyalty.

ERISA fiduciaries can be personally liable for plan losses that result from breaches of their fiduciary duties and, in extreme cases involving willful malfeasance, may be criminally liable. ERISA authorizes enforcement by both the Department of Labor and private causes of action instigated by impacted participants and beneficiaries. While ERISA does not authorize punitive damages, it does permit courts to award attorneys' fees.

401(K) FIDUCIARY LITIGATION: TRENDS AND COMMON TYPES OF CLAIMS

401(k) plans have become the predominant form of employer-sponsored retirement vehicle. According to data compiled by the Investment Company Institute, 401(k) plans held over $5.6 trillion in assets as of September 30, 2018; by far the largest single category of private sector retirement program.[2] In addition, the majority of private sector employees that are covered by an employer-sponsored retirement plan are covered by only a defined contribution plan, such as a 401(k) plan.[3]

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[1] ERISA § 404(a)(1)(B).

[2] See INVESTMENT COMPANY INSTITUTE, Frequently Asked Questions About 401(k) Plan Research, available at: https://www.ici.org/policy/retirement/plan/401k/faqs_401k (visited *March 20, 2019*).

[3] Bureau of Labor Statistics, U.S. Department of Labor, *The Economics Daily*, available at: https://www.bls.gov/opub/ted/2018/51-percent-of-private-industry-workers-had-access-to-only-defined-contribution-retirement-plans-march-2018.htm (visited *March 20, 2019*).

The growth in 401(k) plans has made them a ripe target for plaintiffs looking for colorable claims of ERISA fiduciary breaches and potential attorneys' fees. According to the ERISA Litigation Tracker maintained by Bloomberg Bureau of National Affairs, there have been more than 150 complaints filed since 2015 related to ERISA fiduciary claims about 401(k) plan investments and fees. This compares to only about 50 such complaints from 2011-2014.

While the complaints in these cases cover a wide range of allegations, many of the claims can be lumped into several broad categories, with the facts alleged in complaints including the following:

- <u>Poor Investment Decisions</u>
  - Mutual fund investment choices that under-perform benchmarks over a sustained period without a change in investment choices being made.
  - Use of money market funds instead of stable value funds that result in lower returns for similar cost and risk.
  - Allowing or requiring investments in employer stock during a period when the stock price drops significantly.
- <u>Excessive Fees Charged by Funds</u>
  - Higher-cost retail class mutual fund shares offered when less expensive institutional class shares in the same fund were available to the plan.
  - The plan offers all, or a high concentration of, higher-cost actively managed funds that underperform less expensive passive index funds.
  - The plan offers custom-built target date funds or models that have a higher cost, and perform worse, than "off-the-shelf" target date funds.
- <u>Excessive Fees Charged by Plan Recordkeepers or Other Plan Vendors</u>
  - Recordkeeper receives large, uncapped revenue sharing fees from plan investments.
  - Recordkeeper fees appear high in the aggregate or on a per-participant basis as compared to peer companies. Sometimes this is paired with allegations that the recordkeeper is entrenched, that the company has failed to check fees against market rates, and that no serious effort to negotiate fees has been made.
  - Additional services (such as investment advice) are provided by an affiliate of the recordkeeper charging a high fee.

- Self-Dealing
    - The plan sponsor is a financial institution and provides 401(k) investments in its own proprietary funds to serve its broader fund management business goals.
    - Recordkeeping fees help subsidize and lower the cost of other administrative fees that would otherwise be paid by the plan sponsor (such as fees for administering nonqualified plans or health and welfare plans).

FOUR KEY ERISA 401(k) PLAN CASES AND MORALS FROM THEIR STORIES

Court decisions in lawsuits can be like Aesop's Fables—timeless tales that teach us morals to live by. While there has been a flurry of 401(k) ERISA fiduciary cases in recent years, sifting through that noise, we think the following four cases provide fable-like teaching opportunities and valuable morals for ERISA fiduciaries.

1. The Price is Wrong: *Tussey v. ABB, Inc.*[4]

The Story: ABB, Inc. ("ABB"), a Fortune Global 500 company engaged in robotics, power, heavy electrical equipment, and automation technology, operated two 401(k) plans, one for salaried employees and one for union employees. Fidelity served as the recordkeeper for those plans, and also provided services related to certain health and welfare plans for which ABB paid the administrative fees. ABB was also responsible for paying a certain portion of the fees for the union 401(k) plan. In the early 2000s, the chair of the benefits committee led a process that resulted in the plans adopting the Fidelity family of target date funds as the default investment alternative, replacing a Wellington balanced fund that had operated in that role. By mapping the Wellington fund investments to the Fidelity target date funds, Fidelity would receive larger revenue sharing fees. Plaintiffs alleged, among other things, that those fees were uncapped, too high, and were not closely reviewed by the company or compared against competitive market prices for the services.

The Holding: The court ultimately held that the benefits committee breached its ERISA fiduciary duties in transitioning out of the Wellington fund. The court seemed particularly concerned with potential self-dealing, in part because a reason to move from the Wellington fund to the Fidelity target date funds may have been to generate greater revenue sharing fees for Fidelity's services to the salaried 401(k) plan, which in turn may have helped the company save costs it would have paid related to the union plan, the health and welfare plans, and the nonqualified plan. This concern with potential self-dealing and duty of loyalty violations further seemed to color the court's view as to allegations about breach of the duty of care, suggesting that the benefits committee processes were weak and that ABB failed to adequately wield its bargaining power in negotiating Fidelity's fees. After these rulings, it took several years and further court decisions and appeals to determine damages and attorneys' fees.

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[4] *Tussey v. ABB, Inc. (ABB II)*, No. 15-2792, 2017 WL 929202 (8th Cir. Mar. 9, 2017).

Morals of the Story: ERISA fiduciaries should fully understand the structure of recordkeeping service agreements and how fees are calculated. It is not enough to rely on a review of investment funds expense ratio. Fiduciaries should regularly check the competitiveness of vendor arrangements as compared to other vendors on the market, and they should generally try to use their size and bargaining power to push for better pricing. If vendor pricing, bundled services, or plan investment fund decisions can impact the fees paid to third parties by the company, fiduciaries should pay particular attention to make sure those fees are calculated in the best interest of plan participants and cannot be perceived as subsidizing a company cost. Even the appearance of making investment decisions depending on the cost of services to the company can make a fiduciary a target for litigation.

2. How ERISA Fiduciaries are Like a Norse God: *Tibble v. Edison International*[5]

The Story: Edison International is a public utility holding company based in California. Since 1999, Edison International and its related benefits committee and investment committee (collectively, "Edison") periodically added retail-class mutual funds as investment options in its 401(k) plan, including in 1999 and 2002. Edison did not appear to consider the institutional share class alternatives, even though identical lower-cost institutional share classes were available. The lower court and the Ninth Circuit held that there had been a breach of fiduciary duty with respect to the 2002 decision to add retail-class mutual funds to the plan, but held that the 1999 actions of Edison were time-barred under ERISA's six-year statute of limitations.

The Holding: The Supreme Court held that ERISA fiduciaries have a continuing duty to monitor investments and remove imprudent ones. This continuing duty to monitor investments is separate from the duty to exercise prudence in the initial selection of investments. The six-year statue of limitations for breaches of fiduciary duties runs not only from the initial selection of investments, but also from each subsequent point at which the fiduciary should have reviewed and potentially changed investments. The Supreme Court remanded the case for the Ninth Circuit to consider the breach of fiduciary duty claims on their merits. The suit was filed in 2007, the Supreme Court ruled on the case in 2015, and plaintiffs received $7.5 million in damages in 2017.

Morals of the Story: In Norse mythology, the god, Heimdall, stands in a sleepless, vigilant watch over Asgard, and when danger approaches, he sounds his horn. ERISA fiduciaries are just like Heimdall. They must stand in a vigilant watch over their 401(k) plans on behalf of participants, and if problems arise, they must act. ERISA fiduciaries must continually and closely monitor the prudence of a plan's investment options and make changes to the investment lineups whenever investments are no longer prudent. It is not enough to "set it and forget it" when it comes to plan investments. While having quarterly or semi-annual meetings to review plan investments may seem tedious, it is necessary and important.

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[5] *Tibble v. Edison International*, 135 S. Ct. 1823 (2015).

3. Stock, Drop, and Roll: *Fifth Third Bancorp v. Dudenhoeffer*[6]

The Story: Fifth Third Bancorp ("Fifth Third") maintained an employee stock ownership plan ("ESOP") within its 401(k) plan, which was primarily invested in Fifth Third common stock. Participants could choose to invest their own contributions in Fifth Third stock, along with several other investment options, and Fifth Third provided matching contributions on participants' contributions in the form of company stock. During the period from 2007 to 2009, as part of the broader global financial crisis, the value of the stock dropped precipitously. Plaintiffs claimed that during this time, Fifth Third's loan portfolio had changed from prime to sub-prime quality without adequate disclosure, and that plan fiduciaries knew it. Plaintiffs alleged there was a breach of fiduciary duties when the plan's fiduciaries failed to act even though they knew or should have known that the employer stock was overvalued and excessively risky (based on public and nonpublic information). In its defense, Fifth Third pointed to the general "presumption of prudence" standard for ESOPs, which by definition are intended to be invested primarily in employer stock.

The Holding: ERISA fiduciaries of plans invested in employer stock are subject to the same duty of prudence that applies to other ERISA fiduciaries, except that they are not required to diversify the fund's assets. Therefore, this case marks the end of the "presumption of prudence" for investments in employer stock, and plan sponsors cannot reduce or waive the duty of prudence simply by requiring investments in the company stock fund. As the Supreme Court noted, plan design cannot override ERISA fiduciary duties. The Supreme Court, however, held that in order to survive a motion to dismiss for a stock drop case, a plaintiff must allege (1) an alternative action that the fiduciary could have taken that would have been consistent with securities laws and (2) that a prudent fiduciary in the same circumstances "could not have concluded" that such an alternative action would do "more harm than good" to plan participants. In subsequent cases, this standard has proven very difficult for plaintiffs to meet, and as a result most stock-drop cases do not survive a motion to dismiss.

Morals of the Story: Even though the holding in *Dudenhoeffer* makes stock-drop cases more difficult for plaintiffs to purse, ERISA fiduciaries should be particularly aware of the performance of employer stock in a defined contribution plan and should continually ensure that employer stock remains a suitable investment choice for the plan. It is helpful to provide participants with enhanced communications regarding the risks of holding employer stock, the merits of diversification, and any new procedures relating to such holdings. Fiduciaries should adopt procedures for evaluating employer stock, which may be different from the procedures adopted for other investments in the plan, due to the unique nature of employer stock and the knowledge of ERISA fiduciaries regarding the company's performance.

[6] *Fifth Third Bankcorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014).

4. Prudently Ever After: *White v. Chevron*[7]

The Story: So far, the stories above have had dark overtones highlighting risks and threats to ERISA fiduciaries—more like a Brothers' Grimm Fairy Tale than an Aesop's Fable. But this next story provides a ray of hope and light. Chevron's 401(k) Plan had over $19 billion in assets and was managed by Vanguard. The plan included a number of Vanguard funds in the investment line-up. The plaintiffs challenged virtually every aspect of the plan, including fiduciary breach claims related to (1) excessive recordkeeping fees tied to revenue sharing and failing to periodically bid out the recordkeeping work, (2) excessive investment management fees tied to mutual fund share classes where identical lower-fee classes were available, (3) the failure to remove an imprudent fund, and (4) the selection of a money market fund rather than a stable value fund for the capital preservation strategy. During the relevant period, Chevron had changed from a revenue-sharing to a per-participant basis for recordkeeping fees, and moved several investments to institutional share classes, but the plaintiffs generally alleged that these steps should have been taken sooner.

The Holding: The court dismissed all claims on a motion to dismiss before discovery. Claims of fiduciary breach require a pleading of specific facts to indicate a flawed fiduciary process. It is not enough for participants to use "hindsight" assertions that show participants could have saved money had different choices been made. In addition, the court held that there is nothing per se impermissible about revenue sharing arrangements, retail class shares, or money market funds. In addition, Chevron periodically made changes to their recordkeeping fees and fund line-up, which implied they were monitoring the plan and fulfilling their fiduciary duties.

Morals of the Story: Have a consistent, documented process for reviewing plan investments, including an investment policy statement that is periodically reviewed and updated. Also have a consistent and documented process for reviewing vendor contracts for the plan including recordkeeper service contracts. Monitor plan fees and investment choices, and make changes to those fees and investment choices when better alternatives become available. Plans are not required to invest in certain types of funds (e.g., money market over stable value funds) or use certain types of investment vehicles, but they should make decisions that are in the best interest of plan participants and document the decision making process.

WHAT SHOULD YOU DO NOW

ERISA fiduciary litigation challenging oversight of 401(k) plans will not go away anytime soon. But plan sponsors and administrators can take the lessons from the case law and apply best practices to limit exposure.

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[7] *White v. Chevron*, 2016 BL 281396 (N.D. Cal. 2016).

In general, qualified individuals should be clearly designated as the plan's ERISA fiduciaries. Those individuals should follow a prudent, documented process and always make decisions that are in the best interest of the plan participants, rather than the company.

More specifically, forming an administrative and/or an investment committee to oversee administration and investment of the 401(k) plan should be considered. The committees should be comprised of individuals that have roles within the company that compliment each other and bring different skill sets to the table. The investment committee should have adequate investment experience to make informed and appropriate investment decisions. The committees may consider engaging outside consultants for investment advice and/or administrative support, as applicable.

The monitoring of investments should be consistent and well documented. Decisions should be made in accordance with governing documents, including an investment policy statement, which itself should be periodically reviewed and updated. Having an investment policy statement is not helpful, however, unless its provisions are followed. Either poorly performing investments should be removed or the company or committee should document the reason why it believes that the investment option is still prudent. New investment options or vehicles should be considered if they present cost savings opportunities or other benefits to participants. The most appropriate investments and investment vehicles will vary by company, but there should be clear documentation of why certain investments and investment vehicles were selected and why they continue to be the most appropriate choices.

Fees should be well understood by the plan fiduciaries and communicated to participants. This is particularly important when fees may come from various sources, some of which may not be intuitive to the average participant, such as revenue sharing fees. In order to clearly communicate plan fees to participants, better disclosures may be needed. The fees charged to plan participants should be compared to the fees charged to plan participants of peer companies with a similar size 401(k) plan to ensure the company's participants are not being overcharged.

Plan fiduciaries should continually monitor the scope of services provided by the 401(k) plan's service providers and the related costs. Companies should regularly (perhaps every 3-5 years) gauge the marketplace to determine if there are more suitable vendors available or if the company may be able to negotiate lower fees, either because its negotiation power has increased or because there are lower-cost alternatives in the marketplace. Companies should not use affiliates of their current vendors for other plan services simply because it is most convenient or more affordable for the company.