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A VIEW FROM THE TRENCHES: RETIREMENT PLAN FEE & INVESTMENT LITIGATION AND RISK MANAGEMENT

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How ERISA Fee Litigation Started; How We Got Here

- On September 11, 2006, the Schlichter Firm filed the first wave of ERISA excessive fee complaints against the employers sponsoring the largest 401(k) plans in the country.
- After some early defeats, plaintiffs retooled their strategy, which had been to challenge the plans in their entirety as overpriced and imprudent.
 - Started suing financial services institutions that offered proprietary investment products to their 401(k) plan participants.
 - Started asserting more pared-down and targeted claims.
- Additional plaintiffs' firms have joined the mix.

Overview of Retirement Plan Expenses



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- Investment Expenses
 - Investment management
 - 12b-1 fees
 - Sales charges
 - Shareholder servicing fees
 - Sub-transfer agent fees
- Administrative Expenses
 - Trustee and custodial services
 - Recordkeeping
 - Daily valuation
 - Participant communications
 - Accounting and legal expenses

Factors That Can Affect Retirement Plan Expenses

- Type of investment vehicles – *e.g.*, mutual fund, separate account, collective investment trust, variable annuity
- “Share class”
- Style of investment management: actively-managed vs. passively-managed/“index”
- Bundled vs. unbundled services
- Scope of services provided to plan participants

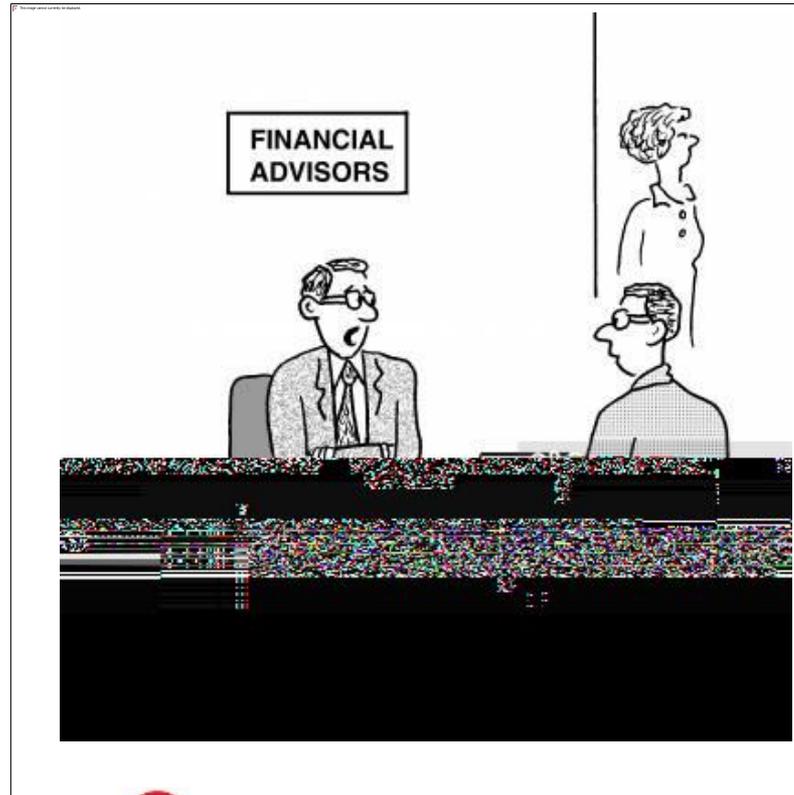
Common Administrative Fee Structures in Retirement Plans

- Asset-based/revenue sharing
- Per-person
- Transaction-based
- Flat rate
- Paid by plan sponsor
- Some combination of the above

Hypothetical Illustration of Revenue Sharing in the Retirement Plan Context

- Step 1: Mutual fund receives the following types of fees:
 - Management (Advisory) Fees
 - Distribution and/or Service (12b-1) Fees
 - Other Expenses
- Step 2: The mutual fund takes some portion of the fees that it receives and pays those fees to the plan recordkeeper.
- Step 3: In some instances, recordkeeper “rebates” revenue sharing payments back to the plan.

ERISA Fee Litigation



Who Are the Targets?

- Plan size: Plans with >\$1B in assets have been prime targets, but as more plaintiffs' firms get into the mix, that has changed.
 - Several recent complaints have targeted mid-size plans with assets between \$100-400M
- Plaintiffs have targeted multiple industries – manufacturing, healthcare, tech, defense contractors, financial institutions, retailers, private universities – and the list keeps growing.
- Plaintiffs' attorneys often use plan 5500s and websites such as Brightscope as a starting point.
- Plaintiffs' attorneys are increasingly using social media (e.g., Facebook and LinkedIn) as a means to solicit plaintiffs.

Why These Cases Are Significant

- Alleged damages add up quickly through a “game of inches”
- Aggressive and active plaintiffs’ bar
- Unlike securities claims, there are no heightened pleadings standards that plaintiffs must meet to survive a motion to dismiss
- No “intent” requirements
- Cases are expensive to litigate if a motion to dismiss is not successful
- Also note: While corporate directors and officers may be named as defendants, these cases are covered only by FLI policies, not D&O policies

Types of Cases

- Nonproprietary/Plan Sponsor Cases – Claims against plan sponsor fiduciaries for imprudent selection of investment options and administrative services
- Proprietary – Claims against plan sponsor fiduciaries for selecting affiliated funds and service providers
 - Employer (generally financial service companies) offering own funds or in-house funds as investment options
 - Using Affiliated Service Providers (trustee/custodian, broker, investment consultant or manager, recordkeeper)
 - Affiliated products (registered funds, CITs, private funds, and insurance products)
 - Participant Level Advice Programs and IRAs

Claims/Issues Raised in the “Plan Sponsor” Excessive Fee Cases

- Excessive Investment Fund Fees:
 - Selecting retail-share class funds when less expensive institutional-share class funds were available
 - Selecting actively-managed funds when less expensive, better performing index funds were available
 - Failing to consider separate accounts or commingled trusts
- Excessive Administrative/Recordkeeping Fees:
 - Fiduciaries failed to negotiate (through RFP or otherwise) reasonable recordkeeping fees or other service-related fees
 - Allowed asset-based, rather than per-capita, fees
- Revenue Sharing: The intersection of the above theories
 - Hidden revenue sharing
 - Excessive or conflict-driven revenue sharing
 - Failure to track total revenue sharing or obtain rebates back to the plan

Recent Complaints – More Refined Theories

- Investment performance claims
 - Plaintiffs allege underperformance versus benchmark (or other comparator) over period of time
 - Plaintiffs can always find a better benchmark
 - Typically, just for some of the investment options on the platform
 - Performance measured versus low-cost, passively managed fund (similar to benchmark)
 - Challenges to TDFs, “custom” investments, “non-traditional” investments, stable value funds, and money market funds
- Plaintiffs continue to challenge investment share class if plan is not in lowest share class available

Recent Wave of Fee Complaints Against Private Universities

- Similar theories, but additional bells and whistles given context of 403(b) plans.
 - Multiple vendors: inefficiencies, inability to leverage plan assets for lower costs
 - Too many options: “decision paralysis,” and cannot qualify for lower-cost shares
 - Actively and passively managed funds in same asset categories
 - Did not offer lower-cost share classes even where available
 - Asset-based revenue sharing for multiple recordkeepers
 - Allowing recordkeeper to require certain investment options be “locked in”
 - “Underperforming” investment options
 - Participant loan program = alleged prohibited transaction

Common Defenses in the Plan Sponsor and University Suits

- **Procedural Prudence**

- Process, process, process. The most important aspect of a plan fiduciary's defense to liability, regardless of outcome.
- Develop detail about fiduciary monitoring and evaluating fees, including negotiations, benchmarking, RFPs, etc.
- Plan's use of an experienced consultant or investment advisor
- Active fiduciary decision-making can be evidence of a sound *process*. But. . . plaintiffs point to changes and argue they could and should have been made sooner.

- **Substantive/Objective Prudence**

- Reasonableness of expense ratios – *Hecker/Loomis/Renfro/Tibble* ranges of reasonable all-in fees
- Reasonableness of RK fees
- Performance of funds – key questions include the appropriate benchmarks, the applicable period, etc.

- **Statute of Limitations**

- Post-*Tibble*, focus is on three-year “actual knowledge” period. Six-year period of repose should still apply to PT claims arising more than six years before suit.

How Plan Sponsor Cases Have Fared To Date

- Some early successes for 401(k) excessive fee cases
 - Don't have to "scour the market" to find and offer cheapest funds available (*Hecker, Renfro*).
 - So long as offer a mix of investments at varying prices, no breach of fiduciary duty (*Hecker, Renfro*).
 - Courts rejected broadside attacks against retail-class mutual funds (*Loomis, Tibble*).
- Mixed results as Plaintiffs refine the theories
 - May be imprudent to offer retail-class mutual funds without investigating whether (cheaper) institutional-class funds were available. "Cannot ignore the power the trust wields to obtain favorable investment products, particularly when those products are substantially identical – other than their lower cost – to products the trustee has already selected." (*Tibble*).
 - Cannot allow revenue sharing to subsidize other non-plan obligations (*Tussey*).
- Claims alleging kickback schemes or self-dealing more difficult to get dismissed outright (*Braden*).
- Courts may deny MTD so they can evaluate the claims on a more developed record.

How the University Complaints Have Fared to Date

- Three complete dismissals: Penn, Northwestern and Wash U
- Other courts have dismissed some but not all claims:
 - Investment underperformance claims have survived
 - Excessive recordkeeping and investment management fee claims have survived
 - Challenges to number of investments have been dismissed
 - Most “locking in” claims have been dismissed
 - Most duty of loyalty claims have been dismissed
 - Share class claims and active vs. passive management claims - a mixed bag
- 4th Circuit recently accepted interlocutory appeal in Johns Hopkins case following district court’s denial of MTD as to core claims
- One trial victory: Sacerdote v. NYU

Key Points from NYU Trial Decision

- **Excessive Recordkeeping Fee Claims:**

- Recordkeeper Consolidation: NYU considered the prospect, but court found legitimate IT/technology impediments.
 - One vendor is not always better/cheaper, and many preferred Vanguard.
 - Court agreed NYU could not map annuities, and annuities had recordkeeping constraints.
- Failure to RFP: NYU issued two RFPs, but the plan's fees also declined steadily over time without RFPs.
- Revenue-Sharing: revenue sharing is fine; rejected expert testimony re: what NYU may have paid under other structures.

- **Underperforming Funds:**

- NYU's process was reasonable. Court criticized Committee members but ruled the process was sufficient, in part due to investment consultant.
- Rejected plaintiffs' proposed benchmarks; found both funds *objectively* reasonable based on the funds' actual benchmarks.

Proprietary Products and Services

- Affiliated Service Providers
 - Trustee/Custodian
 - Broker
 - Investment Manager
 - Adviser/Consultant
 - Recordkeeper
- Affiliated products, e.g., registered funds, CITs, sep. accounts, insurance products
- Participant Level Advice Programs
- Employee IRAs

Proprietary Fund Cases – Common Allegations

- Prudence/Loyalty
 - Selection of proprietary funds is based on generating revenue for the service provider “at the expense of” participants’ best interests and for the benefit of the plan sponsor, violating ERISA’s duties of prudence and loyalty.
- Prohibited Transaction Claims
 - Party in interest/conflict/self-dealing claims under Section 406.
- “Seed” allegations
 - That new service providers created to manage plan assets and then sold for a profit used the plan to “boost” the sale price; the plan should be compensated for sale of business
 - That new funds whose first or primary investors are the service provider’s own plan participants “seeded” the establishment of the funds
- Plaintiffs’ bar has been actively filing new proprietary fund complaints in recent years.

Key Defenses in Proprietary Fund Cases

- Prudence/Loyalty
 - Reasonable process in evaluating fees
 - Substantive prudence
- Prohibited Transaction Claims
 - Reasonableness of fees under ERISA Sections 408(b)(2) and 408(c)
 - PTE 77-3 (mutual funds/ETFs) – dealings with investment company must not be on terms that are less favorable than between the investment company and any other shareholder.
- Charging of direct costs can be permitted.
- Statute of limitations

Recent Rulings and Developments

- ***Meiners v. Wells Fargo* (8th Cir. Aug. 3, 2018)**

- Challenge to the offering of Wells Fargo target-date funds in Wells Fargo’s 401(k) plan.
- Plaintiffs alleged the plan was used to seed the funds (which were the plan’s default investment options) and funnel fees back to Wells Fargo through multiple layers.
- Court affirmed dismissal of the complaint (a rarity in these cases).
 - In short, it is not enough to state a claim to compare funds to 1-2 lower-cost, better-performing alternatives. Here – Vanguard and Fidelity target-date options.
 - Must offer a *meaningful* benchmark, to allow for a “sound comparison” of the fund being challenged to the “market at large.”
 - Duty of loyalty – a plaintiff must first plausibly allege a fund is imprudent *before* obtaining a reasonable inference it was chosen for an improper reason.

Recent Rulings and Developments

- ***Brotherson v. Putnam Investments* (D. Mass./1st Cir.)**

- Putnam’s plan offered exclusively Putnam funds until 2016.
- March 2017: Court granted summary judgment to Putnam on PT claims, but denied for fiduciary breach claims.
 - Court rejected using Vanguard index funds as comparators to Putnam funds as apples-to-oranges, as Vanguard is known to offer passively-managed funds “at cost.”
- June 2017: After plaintiffs’ trial evidence, court granted Putnam’s motion for judgment.
 - No evidence of disloyalty; must be something beyond self-dealing.
 - Court found potential procedural breaches, but plaintiffs failed to prove prima facie case of loss to the plan. A procedural breach does not automatically taint the entire plan lineup.
- First Circuit heard oral argument in April 2018, meaning a ruling could be any time.

The Settlement Landscape

- \$62 million, *Lockheed Martin*
- \$27.5 million, *Ameriprise Financial*
- \$57 million, *Boeing*
- \$32 million, *Novant Health*
- \$30.9 million, *Mass Mutual*
- \$30 million, *International Paper*
- \$21.9 million, *Deutsche Bank*
- \$16.5 million, *Caterpillar*
- \$15 million, *General Dynamics|FAMCO*
- \$18.5 million, *Bechtel*
- \$9.5 million, *Kraft*
- \$6.5 million, *University of Chicago*

Potential Risk Factors - What Do Plaintiffs Look For?

- Separate accounts or collective trusts vs. mutual funds
- Institution share class vs. retail share class
- Index/passively-managed funds vs. actively-managed funds
- Proprietary investments (of plan sponsor/fiduciary or recordkeeper) vs. open platform
- Number of investment options - Goldilocks
- Number of recordkeepers
- Use of revenue sharing without caps or rebates to the plan
- Are fiduciaries getting competitive bids for recordkeeping?
- Offering of and/or heavy investment in investments with high expense ratios
- Plan asset size
- Industry segment

How Can Fiduciaries Seek to Minimize Risk?

- **Process** is paramount under ERISA, especially the process to evaluate investment options and service providers
 - Fiduciaries are not required to guarantee a good outcome, but courts look at whether they follow a good process
 - Appropriately document the process to demonstrate basis for decision-making
 - Delegations of authority should be periodically and carefully reviewed
 - Regular meetings of fiduciary committees
 - Meeting “books” and agendas
 - Resolutions
 - Minutes
 - In general, seek good fiduciary housekeeping.

THANK YOU

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