401(k) Plans

Understanding the Lawsuits Targeting University Retirement Plans

This column examines the recent lawsuits, filed primarily by the law firm of Schlichter Bogard & Denton, against 12 universities regarding their ERISA retirement plans. Understanding these suits and reacting appropriately is critical for fiduciaries and boards of institutions that sponsor retirement plans, particularly 403(b) plans.

By Michelle M. Ueding

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If you slept well between August 9 and August 17, 2016, you likely do not work in higher education or with higher education retirement plans. During this time, many of us woke up each morning to discover which university or universities received a complaint alleging their retirement plan was poorly invested and too expensive. By August 17, 13 complaints had been filed against 12 universities—Massachusetts Institute of Technology, New York University, Yale University, Duke University, University of Pennsylvania, Vanderbilt University, Johns Hopkins University, Emory University, Columbia University, Cornell University, Northwestern University, University of Southern California, and Columbia University.

The complaints challenge the traditional higher education retirement plan model and advocate a particular plan design as the only prudent solution. I do not believe these complaints will lead to courts rejecting traditional higher education retirement plan designs. However, the complaints should cause every institution to engage in robust discussions and revisit their fiduciary process. For those of you that transformed your plan in connection with the 2007-2009 "perfect storm" of new IRS regulations and DOL filing requirements for 403(b) plans, this will mean making sure your reaction to the storm has become a disciplined and constant process. For those of you who quickly became compliant but did not change your approach or have yet to form a fiduciary committee, this will mean engaging in the difficult process of documenting where you are and figuring out how to change for the better without overreacting.

This column begins by explaining what happened prior to the complaints, the design of the university plans involved, and the allegations the universities will face in court. I will next explain what I expect to result from these complaints. Finally, I will explain what you should do in response to the complaints.

What Happened

The filing of the complaints in August 2016 signaled the end of a long process. The St. Louis law firm that brought 12 of the 13 complaints started the process of educating itself on how to sue a retirement plan sponsor over 10 years ago. It honed this process, targeting the top one percent of retirement plans by asset size—what its attorneys refer to as "jumbo" plans. The firm learned to aggressively pursue employees to bring or join in suits, in some instances taking out advertisements with the names of targeted sponsors in local newspapers. It was credited with both the largest settlement and the most significant recent US Supreme Court decision relating to private-sector 401(k) plans. In extending this process to 403(b) plans, the law firm likely began conversing with the employees and former employees who brought the complaints and collecting plan notices and documents at least a year in advance.

The 13 substantially similar complaints filed against "jumbo" university retirement plans raise many of the issues presented in the prior complaints against the 401(k) plan sponsors. Smaller institutions may be tempted to breathe a sigh of relief here. However, remember that success and a road map (in the form of a relatively standard complaint) will encourage other law firms to consider similar litigation.

The Design of the Plans

These complaints challenge the traditional higher education retirement plan model. What I mean is that the sued universities generally had multiple 403(b) plans and that each plan allowed participants to select where to send contributions among anywhere from a couple to a handful of vendors (or platforms), including Fidelity, TIAA, Vanguard, VALIC, American Century, Calvert Investments, and Prudential. All but one of the universities had two or more vendors. Further, in most cases, little was done by the university to restrict participant choice of investment options. In other words, the university had not selected a short list of investments and restricted participants to that list of options. In many cases, the participants could choose any investment option available on the particular platform. Almost all of the sued universities offered more than 100 investment options, with many offering more than 300.

Design Changes Made by the Plans in Recent Years

Some of these universities had reduced the number of vendors (consolidated) prior to the complaint being filed against them. Yale consolidated assets that were previously record-kept by Vanguard and TIAA and began using only TIAA effective April 2015. Vanderbilt consolidated recordkeeping services and only offered Fidelity beginning April 2015. Johns Hopkins reduced the number of record-keepers servicing its plan from five to three in January 2016. Northwestern consolidated the assets of one of its plans with TIAA in 2012. The University of Southern California froze contributions to one of the four record-keepers servicing one of its plans in March 2016. MIT changed to a single record-keeper (Fidelity) 16 years ago and created a short menu with 37 investment options in July 2015.

The Allegations

Each of the complaints tells a similar story regarding the particular university's alleged wrongdoings. In general, the story (with slight variations) goes something like this:

General Allegations. The university is a sophisticated university with lots of expertise and renown. It maintained one or more retirement plan(s) subject to the Employee Retirement Income Security Act of 1974 (ERISA). The university and individuals responsible for the plan(s) are subject to the ERISA fiduciary standard, which is the highest fiduciary standard under law. This standard applies to the decisions on what and how many vendors (such as record-keepers) to use and what and how many funds to use. ERISA requires monitoring these decisions; therefore, keeping a fund or a vendor without monitoring it is a fiduciary breach.

The complaints develop these allegations by stating the plaintiff's view of the industry standard and what action this industry standard compels of the fiduciary. At least six industry standards are mentioned:

First, selecting a vendor to provide recordkeeping services is like purchasing a commodity—there is very little differentiation between services provided by the various vendors, and competitive bidding provides the best price. As a result, ERISA's prudence requirement requires conducting a competitive bid for record-keepers. Most plans allegedly conduct this process approximately every three years.

Second, the number of participants is the biggest factor in determining recordkeeping cost—the amount of assets is irrelevant. As a result, prudent fiduciaries negotiate a fixed per-participant fee. If a fiduciary allows the investment funds to pay the record-keeper (for example, uses revenue sharing) or otherwise allows a fee that is asset-based, it must continually monitor any amount the record-keeper receives and negotiate caps and refunds of excess fees.

Third, using more than one platform is a breach of fiduciary duty because it involves paying more than one vendor to do the same thing, makes more work for the university, and confuses participants.

Fourth, only an extremely rare (if any) investment manager can produce investment performance greater than that achieved by a passively managed fund after fees are taken into account. As a result, prudent fiduciaries use passively managed investment options (for example, index funds). If a fiduciary uses actively managed investments, it must engage in an extensive process of documenting why the active manager is appropriate when index funds are available.

Fifth, a prudent fiduciary considers price a primary consideration in selecting investment options and controlling expense ratios to be the best way to deliver value to the participant.

Sixth, "jumbo" plans have incredible buying power because lower expense funds are available to these plans for the asking. As a result, prudent fiduciaries use the full buying power of the plan assets by: (1) never using a retail fund (generally the highest expense share class available); and (2) selecting a short investment menu that leverages the full amount the plan invests in a particular fund category (*e.g.*, large company growth) to buy the lowest expense ratio fund available in that category.

After measuring the particular university plan against the industry standards, the complaints concluded the fiduciaries of the particular university plan breached their duty by: (1) failing to consolidate the plans with a single record-keeper; (2) failing to monitor record-keeper fees, to conduct a competitive bidding process for recordkeeping services, and to negotiate flat-fee rates; (3) offering excessive numbers of investment options under each plan; (4) retaining high cost, underperforming, active funds when passive index funds were available; and (5) failing to review or select various low-cost options, including lower-cost share classes and separate accounts. The complaints allege that damages should be measured by the difference between the fees paid by the plan and the fees the plan would have paid if the lowest-cost index fund available in each asset class were offered by the plan. With these general allegations in mind, it is worth discussing a few additional allegations concerning specific funds to help understand the complaints.

Additional Specific Allegations. The complaints highlighted a number of specific funds as being allegedly problematic either for performance issues or because of excessive fees. The CREF Stock Account and TIAA Real Estate Account are specifically described as high on fees and low on performance. The complaints also highlight the expenses and restrictions associated with the TIAA Traditional Account and CREF variable annuities. Additionally, the complaints mention additional expenses charged by VALIC variable annuities and the imprudence of offering Fidelity specialty funds. In situations where the plan fiduciaries made changes to vendors or investment options in recent years, the complaints claim these actions and the participant communications sent in connection with the change are evidence that the plan fiduciaries knew that maintaining a larger plan menu was imprudent.

Caveats. At this stage of the litigation, it is important to keep in mind two things regarding the allegations. First, the complaints are based on public information available and notices distributed to participants. Discovery has not yet occurred. As a result, the only thing the plaintiffs likely know concerning the fiduciary decisionmaking process is what can be discerned from reading a participant notice. For example, if a university consolidated or froze a vendor, it may have included little information regarding the basis of its decision in the participant announcement concerning the change.

Second, the allegations are not necessarily supported by opinions of the DOL or a court. A large number of actions brought against retirement plans relating to these matters (often referred to as "excessive fee cases") settle. Because of the large number of settlements and the newness of excessive fee cases, we have very little in the way of court precedent. The complaints claim their allegations are based on established best practices and well-accepted conclusions of academic studies. However, the complaints do not present the full story—complaints, by their nature, are one-sided. Some of the factors they ignore are: (1) differences in the industry standard for 401(k) plans versus for 403(b) plans; and (2) disagreement among practitioners regarding matters like plan and investment design. I will admit that I am seeing more agreement on best practices among practitioners. However, I am convinced the trend is in part because of the bringing of these complaints first against 401(k) plans and now against 403(b) plans, so a claim by the law firm drafting the majority of the complaints to this effect seems like a self-fulfilling prophecy.

Expectations

With this background in mind, I will discuss what I expect to happen as a result of these complaints. As I said before, the complaints challenge the traditional higher education retirement plan model and advocate a particular plan design. The complaints suggest that every 403(b) plan should use only one recordkeeping platform, maintain as investment options a short list of index funds, offer the lowest-priced share class of each of those funds, and negotiate a flat fee based on the number of participant accounts in the plan. While I agree this would be a prudent design, it is not the only prudent design. Therefore, although these lawsuits are a call to action or a reminder of why you do what you do as a fiduciary committee, you should not expect a Supreme Court decision saying the traditional 403(b) plan design is imprudent. However, I do expect to see a significant number of settlements, a growing push toward sameness of plan design, and court decisions reminding us of the importance of prudent process.

Settlements. I will not spend much time on why we will see more settlements. As I mentioned before, a large number of excessive fee cases settle. This is not unique to excessive fee cases—most court actions settle rather than go to trial. Settlements happen because litigation costs are high and litigation can take several years. Fiduciary insurance carriers, not the universities, often make the settlement decision. ERISA allows participants to recover court costs, and roughly a third of any settlement is generally used to pay attorney's fees. In turn, the large number of settlements will drive the next change I expect to see—a growing push toward sameness of plan design.

Sameness of Plan Design. Settlements make the news, and as a result plan sponsors hear about the large settlement amount and the conditions of the settlement. With little in the way of court decisions, these settlements, although they have no precedential value, become best practices. Prior settlement agreements in excessive fee cases required plan sponsors to receive fiduciary training, remove or restrict an investment option(s), hire an independent fiduciary, add passive investment funds, remove proprietary funds, purchase a lower expense ratio share class, change to a flat-fee arrangement, and conduct a request for proposal.

Publicity regarding these settlements fosters discussion concerning the settlement content and, statistics would suggest, lead plan sponsors to take like action. For instance, both the use of index funds and flat-fee pricing has increased among retirement plans since the first 401(k) excessive fee lawsuit from the law firm bringing the current round of complaints. Therefore, I believe we will see more movement to the designs advocated by the complaints because some of these cases will settle, and the settlement terms will likely include terms similar to prior settlement agreements. Conversation regarding these issues is good from a fiduciary perspective. However, I do not think plan sponsors are learning to be better fiduciaries if the conversation is short and ends with a quick decision to follow the "guidance" provided by the latest settlement. I fear "sameness" (adopting the plan design most often advocated by excessive fee litigators) is not in the best interest of retirement plan participants and beneficiaries. The idea that every fiduciary committee, considering the needs of thousands of diverse populations of participants, would arrive at a similar menu design despite the numerous variations available seems irrational.

Court Decisions. I do not expect all of the university complaints to settle. With respect to those complaints that do not, there are a number of court decisions, issued in response to similar complaints from the same law firm, that do a better job of reminding us about the ERISA duties of prudence and loyalty. As a result, I expect decisions in the cases litigated to be generally favorable to the universities.

For instance, in one case, a plan sponsor had a menu consisting of 26 investment options (23 of which were Fidelity mutual funds) and a mutual fund brokerage window. Expense ratios for the plan's 26 investment options ranged between .70 and 1.0 percent as compared to the single basis point expense ratios being advocated in the university complaints. The court said:

> The fact that it is possible that some other funds might have had even lower ratios is beside the point; nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems). [Hecker v. Deere & Co., 556 F.3d 575 (7th Cir. 2009)]

This shows that, contrary to the allegations in the university complaints, a university is not automatically imprudent by virtue of not offering the lowest-cost funds on the market.

Another court granted summary judgment where a plan sponsor allegedly breached its fiduciary duties by offering mutual funds with unreasonable fees and expenses and by offering actively managed investment options. The court stated:

> ERISA does not require a fiduciary to take "any particular course" so long as the fiduciary's decision meets the prudent person standard. [*Taylor et al. v. United Techs. Corp.*, No. 06-cv-1494, 2009, WL 535779 (D. Conn. Mar. 3, 2009), *aff'd*, 354 Fed. App'x 525 (2d Cir. 2009)]

The notion that a fiduciary need not take any particular course of action as long as its decision is prudent stands in contrast to the complaints' push for sameness of plan design.

Very recently, a district court granted a motion to dismiss where the plan sponsor offered a money market fund instead of a stable value fund, offered some retail funds, and allegedly delayed removing an actively managed fund that was performing poorly. In this case, the court reminded the plaintiffs that:

> ERISA imposes on fiduciaries a duty to act prudently "under the circumstances then prevailing." This standard focuses on a fiduciary's conduct in arriving at an investment decision, not on its results and asks whether a fiduciary employed the appropriate methods to investigate and determine the merits of a particular investment. [*Chevron v. White*, US District Court for the Northern District of California—08/29/2016 quoting *Pension Benefit Guar. Corp. ex rel. St. Vincent v. Morgan Stanley*, 712 F.3d 705, 716 (2d Cir. 2012)]

The court based its dismissal (1) on evidence that the fiduciaries had considered the options available and then made a decision; and (2) on the assertion that fiduciaries may consider factors other than price. Both of these grounds are at odds with the 403(b) complaints.

I acknowledge we may see these cases again on appeal and that these decisions were all made relatively early in the litigation process. Further, I have to admit that, from a best practices perspective, I do not necessarily agree with the existing plan designs described in these cases. However, the legal concept being upheld may be the most important thing you need to understand regarding fiduciary duty—prudence is a process, not a decision. If I have a prudent process, follow my process (including following the terms of all plan documents), and make a decision considering only the interests of the participants and beneficiaries, I have met my fiduciary duty. Having discussed what I expect the outcome of the cases to be and the importance of process, I will close by discussing what you should do in light of these complaints.

What You Should Do

As I said before, these complaints should cause every institution to engage in robust discussions and revisit their fiduciary process. I also said I do not think it is in the best interests of plan participants and beneficiaries to adopt the exact plan design advocated by these complaints, or any settlement, because neither qualifies as law or court precedent. The law requires a prudent process. Some courts have said that if a fiduciary happens to make the decision a prudent fiduciary would have made without a prudent process or without following its prudent process, there is no breach. I recommend having and following a prudent process, because hoping for good luck seems risky.

How You Should Do It. In outlining a prudent process, I will start with the easy example. Many 403(b) plan sponsors responded to what I previously called the "perfect storm" by not only bringing their plan documents up to date and hiring a plan auditor, but also by forming a fiduciary committee. This committee meets regularly to review investments. If this is your institution, now is the time to make sure this is a meaningful process. I would focus on three things:

First, ask whether the delegation of authority to the committee from your board of trustees is well-documented. A well-documented delegation (1) makes it clear that the committee and not the board makes the decisions, and (2) provides the board an easy way (such as a report) to monitor fiduciaries without participating. The 403(b) complaints claim the university boards failed to monitor retirement plan decision making. Boards do not generally have significant time to devote to these matters; therefore, you need to make monitoring easy for them.

Second, have a list of topics you will cover every year. This list should cover the big topics—investments, administration, service provider fees. Subtopics should also be on the list, such as reviewing target date funds, required participant notices, delegations, and fiduciary training. There should be a subtopic for new ideas and trends. Discuss these and decide whether they are worth exploring further. I do not believe you can create a meaningful process by using only the standard fiduciary materials offered by your investment advisor or record-keeper. I say this for two reasons: (1) if the materials belong to someone else, you are more likely to spectate and not participate; and (2) a fiduciary must make decisions based on the best interests of plan participants and beneficiaries. The ERISA standard is not participants and beneficiaries generally, but your plan's participants and beneficiaries. Standard materials will not take the "your plan" part into account.

Third, ask questions and write down the answers. We do not know if any of the universities sued breached their fiduciary duties based on the complaints. As the cases I described above explain, the end result is not judged as prudent or imprudent in a vacuum. Whether they breached their duty will be determined from the documentation the fiduciaries created and retained. Plaintiffs win when there is no evidence the fiduciary considered the options available. An investment review book rarely proves this by itself. You should develop a list of questions you ask concerning your investments annually and every time you choose or remove an investment.

Now for the Tough One. How should the other institution—the one that quickly "became compliant" but did not change its approach or form a fiduciary committee—engage in robust discussions? I will start by saying catch up and put in place now a disciplined process that embraces the principles described above. As for the past, document what you have done. Maybe your process was not formal, but you considered the issues from time to time. Create a record of those occasional meetings. Some fiduciaries may also have a meeting where the parties involved (your historians) document the thought process behind the design in place (vendor(s), investments, and so on). I would not recommend doing this alone. An attorney can help gather the information, ask the right questions, and draft minutes. To illustrate what this might look like, I will take some facts from the 403(b) complaints.

An Example. A university maintains a 403(b) plan with two vendors—TIAA and Vanguard—and over 70 investment options. Over the years, university staff met with representatives of TIAA and Vanguard regarding their products. TIAA and Vanguard provide education and one-on-ones to participants, and the university receives feedback from employees concerning these meetings. The university should gather information received from vendors, documentation of internal review of the vendors, and copies of contracts and disclosures. The university should discuss the prudence of their current design. Discussing the elements of this traditional 403(b) model challenged in the complaints is a useful way to have the discussion.

As I mentioned earlier, the complaints discuss why a two-vendor design is imprudent. Some factors (if true) a fiduciary in this example might consider in deciding if this design is prudent include: (1) plan participants use and value the TIAA annuities; (2) participants generally leave their funds in the annuities throughout retirement; (3) TIAA designs products specifically for the higher education market based on the data it maintains on the saving behavior of higher education plan participants; (4) TIAA account balances cannot be supported efficiently on another platform; (5) TIAA provides extra support to our participants it would not provide as a frozen vendor; (6) Vanguard provides better pricing on its funds and education when we use its platform instead of including it on another platform; and/or (7) plan participants recognize Vanguard and TIAA as experts in the industry and therefore engage more with the plan and the investment menu. Documentation of these various propositions would be important and would still need to be coupled with an evaluation that the price paid for the services received is reasonable.

The complaints also suggest particular TIAA investment funds perform poorly in comparison to their peers. In this example, the fiduciary would need to document the method for evaluating those investments. Interestingly, the investments mentioned are unique investments. The CREF Stock account invests in stocks that are in more than one index (foreign and domestic), and the TIAA Real Estate account invests in real property, not real estate investment trusts (REITs). This makes these funds more difficult to evaluate, and it would be especially important to document the method for evaluating them (*e.g.*, the proper peer group and benchmark).

The complaints also allege it is imprudent to provide participants too many funds because they will not make good investment choices in this circumstance, citing sociological studies and stating that the use of too many funds spreads, rather than uses, a plan's buying power. The courts tell us a fiduciary may consider factors other than price. In this example, a fiduciary should document other factors considered and study whether participants are making good investment choices. Vendors regularly provide information regarding retirement readiness that might help with the latter concern. One factor a fiduciary might consider with respect to the number of funds is what its investment philosophy has been. For private companies that sponsor 401(k) plans, the focus has always been on group savings. Defined benefit plans, profit-sharing plans, and the early 401(k)s were about the employer managing and providing retirement for the employee. Initially, these plans were managed or provided only a very few options.

One could argue that 403(b) plans were originated out of a different philosophy. Institutions provided generous contributions to employees, but they also provided them independence on how best to prepare themselves for retirement, particularly with the non-ERISA, employee-only-funded, tax-deferred annuities. A 403(b) plan fiduciary is not required to adopt a 401(k) philosophy for its 403(b) plan. However, an ERISA 403(b) plan fiduciary has to meet the requirements of ERISA. This means the investment philosophy should be determined considering only the best interests of the plan participants and beneficiaries; these could change over time, so a philosophy should be revisited. Further, the Supreme Court has told us that whatever investment options are selected have to be regularly monitored. [Tibble v. Edison International, 135 S. Ct. 1823 (2015)] This might restrict your ability to offer options. Further, the DOL, which administers ERISA, has suggested employers must designate investment options; they cannot place the ability to select investments entirely in the hands of participants. {Field Assistance Bulletin 2012-02R}

Conclusion

The university complaints represent another step in a process that began with plaintiffs' law firms targeting private-sector 401(k) plans on issues regarding retirement plan fees. I believe, based on the results of those cases, we will continue to see settlements that seem to encourage a shift toward the plan design advocated through the complaints. The complaints that are litigated will likely provide court decisions that favor fiduciaries with a disciplined process and refuse to approve any plan design or type of investment. With that in mind, plan sponsors with established committees should ensure their current process is meaningful and well documented. Other plan sponsors should document where they are and move to a disciplined process. Either way, assuming the plan designs advocated in the complaints is a prudent design is not the right answer. ■