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# BULLETIN

TO: Defined Contribution Plan Clients
FROM: Saltzman & Johnson Law Corporation
DATE: February 16, 2022
RE: Duty to Monitor Investments and Fees

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On January 24, 2022, the United States Supreme Court[1] in *Hughes v. Northwestern University*, 2022 U.S. Lexis 622 (2022) ("Hughes") again emphasized plan fiduciaries duty to monitor investments as well as recordkeeper fees and remove imprudent investments. This memo explains the Supreme Court decision and other relevant decisions concerning defined contribution plans[2].

## ERISA Fiduciary Provisions

The relevant cases each revolve around alleged breaches of fiduciary duties of loyalty and prudence. ERISA requires plan fiduciaries to act "solely in the interest of [plan] participants … for the exclusive purpose of (i) providing benefits to participants … and (ii) defraying reasonable expenses of administering the plan[.]" ERISA §404(a)(1)(A); 29 U.S.C. §1104(a)(1)(A). ERISA also requires plan fiduciaries to discharge their duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims." ERISA §404(a)(1)(B); 29 U.S.C. §1104(a)(1)(B).

To evaluate whether a plan fiduciary has breached their fiduciary duty of prudence, courts focus "not only on the merits of the transaction, but also on the thoroughness of the investigation into the merits of the transaction." *Howard v. Shay*, 100 F.3d 1484 (9th Cir. 1996).

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[1] The decision was 8-0, as Justice Barrett did not take part in the decision.

[2] Defined benefit plans are generally not subject to claims from participants, as the Supreme Court decided in *Thole v. U.S. Bank N.A.*, 140 S. Ct. 1615 (2020) that participants are required to suffer a financial injury in order to pursue these fiduciary breach claims. Thus, if it is anticipated the participant will receive the full amount of their pension benefit, they lack standing to sue (although the Department of Labor still has standing to bring suit). The Court left open the possibility that a participant might be able to bring a claim where mismanagement of the plan was so egregious that it substantially increased the risk that the plan would fail and be unable to pay the participants' future pension benefits.

**Types of Claims**

There have been dozens of class action suits filed in recent years against defined contribution plans. In those class action suits, the plaintiffs are representative plan participants in single-employer plans and the defendants include the plan sponsor, plan committees, other plan fiduciaries and certain plan service providers. Some of the more common claims include:

(1) Using Retail Class Shares Instead of Investment Class Shares - Offering retail class shares (with higher fees for participants) instead of using the plan's size to negotiate institutional class shares for substantively the same investment. *Braden v. Wal-Mart Stores*, 588 F.3d 585 (8th Cir. 2009).

(2) Using Active Investment Management Instead of Index Funds – Using active management funds, with higher fees, rather than well-established, low-fee and diversified market index funds. *Brotherston v. Putnam Invs.*, LLC, 907 F.32d 17 (1st Cir. 2018). Cost is not the only consideration, though. A fiduciary may reasonably select an investment alternative in view of its different risks and features, even if the investment option turns out to yield less than some other option. *White v. Chevron Corp. (White II)*, 2017 U.S. Dist. Lexis 83474, at *30 (N.D. Cal. May 31, 2017), aff'd 752 F. App'x 453 (9th Cir. 2018).

(3) Revenue Sharing and Offsetting Record-Keeping Fees – Revenue share is a rebate of fees charged to the plan by mutual funds and are often used to offset record-keeper fees and other provider fees. DOL Advisory Opinion 2003-09A and 2013-03A. While there is nothing wrong, in principle, with paying a record-keeper through revenue sharing, a fiduciary's failure to ensure that recordkeepers charged appropriate fees and did not receive overpayments can be a violation of ERISA. *Hay v. Gucci Am., Inc.*, 2018 U.S. Dist. Lexis 171193, at *18 (D. N.J. Oct. 3, 2018). Fiduciaries must determine whether the fees were appropriate for the services, as well as be watchful of potential conflicts of interest, such as the recordkeeper hiring its affiliates to sub-advise funds and thereby increase its fees. *Id.* at *19-20. Similarly, record-keeping fees can rise to the level of being imprudent. *Karolyn v. Novant Health, Inc.*, 131 F. Supp. 3d 470, 489 (M.D. N. C. 2015).

However, if a plan has a provision requiring class action waiver and arbitration of all ERISA claims (except for claims for benefits), a class action lawsuit for breach of fiduciary duty is of less concern. *Dorman v. Charles Schwab & Co.,* 2019 U.S. Dist. Lexis 24735 (9th Cir. 2019).

**Supreme Court Decisions**

The Supreme Court has made clear that fiduciaries have a *continuing* duty to monitor trust investments and remove imprudent ones. *Tibble v. Edison*, 135 S. Ct. 1823, 1828 (2015). The Supreme Court relied heavily on its analysis in *Tibble* when deciding *Hughes*. In *Hughes*, the plaintiffs, plan participants, alleged that the Trustees violated their duty of prudence by offering needlessly expensive investment options and paying excessive recordkeeping fees. The Seventh Circuit held that the plaintiffs clams failed because the types of funds that plaintiffs wanted, low-cost index funds, were among the over 400 different options available. The Supreme Court rejected this reasoning as too narrow – just because some funds were appropriate did not mean that "[plaintiffs] could not complain about the flaws in other options." The Supreme Court did not rule directly for the plaintiffs, but required the lower courts to reevaluate the claims as a whole.

Practically speaking, this decision requires plans to regularly monitor each of their investment options and eliminate those that are underperforming or charging higher fees than their benchmarks without a reasonable justification for doing so. The Court recognizes that "the circumstances facing an ERISA fiduciary will implicate difficult tradeoffs" and requires the courts to give some deference to the decisions made by a reasonable fiduciary. Documenting the investigation and monitoring process is also key.

**Multiemployer Plan Decisions**

So far, virtually all of the class action suits involve single-employer plans, particularly against large companies, health systems and universities as described above. Two class action suits have been brought in California against multi-employer plans.

In one of them, *Klawonn v. Bd. of Dirs. for the Motion Picture Indus. Pension Plans*, 2021 U.S. Dist. Lexis 152355 (C.D. Cal. Aug. 29, 2021), the plaintiffs brought two claims for breach of the fiduciary duty of prudence: (1) the plan's use of a Trustee-directed strategy for all plan participants, without the opportunity for participants to direct their own investments; and (2) failure to reconsider investments in actively managed hedge funds, which have overly high fees and comparatively poor performance. The district court dismissed the first claim without leave to amend because Trustee decision to have an investment manager control all pooled assets was an element of plan design, not a fiduciary act. As to the issue of high fees, the court noted that courts also look to other indications that the plan fiduciaries' decision-making process was flawed, such as the investments' underperformance and the fiduciaries' potential breaches of loyalty via self-dealing or improper influence. The complaint alleged that the plan was one of the most expensive plans in the country, with fees between four and five times higher than other comparable plans, as well as underperforming its own benchmark by more than 50% over a recent 5-year period. The court found that plaintiffs failed to compare the plan's investments with specific other offerings. Plaintiffs amended their complaint and the judge's ruling on the motion to dismiss is currently pending.

In the other case, the plaintiffs brought claims for breach of the fiduciary duties of loyalty and prudence, by offering retail class shares instead of less expensive institutional shares of the same fund. *Ybarra v. Bd. of Trs. of Supplemental Income Trust Fund*, 2018 U.S. Dist. Lexis 139928 (C.D. Cal. April 24, 2018). Plaintiffs also alleged that the board of trustees lacked adequate processes for selecting and monitoring the revenue-sharing arrangement with the recordkeeper, leading to the overcharging of plan participants. The district court twice rejected the plan's motion to dismiss, which allowed plaintiffs to continue discovery. The case ultimately settled for $8.75 million.

**Steps for the Plan to Protect Itself**

Plans can continue to take a number of steps to help prepare them against the possibility of these lawsuits such as:

(1) Recordkeeper Fees – The Plan's investment consultant should regularly review and report to the Trustees whether the recordkeeper fees are in line with the market. While fiduciaries are under no obligation to regularly conduct competitive bidding for recordkeeping services, plaintiffs can bring claims alleging the failure to do so is a violation of their fiduciary duties. (*Kong v. Trader Joe's Co.*, 2020 U.S. Dist. Lexis 181013 (C.D. Cal. Sept. 24, 2020); *Tobias v. Nvidia Corp.*, 2021 U.S. Dist. Lexis 173539 (N.D. Cal. Sept. 13, 2021). The

failure to regularly review recordkeeper fees can lead to a breach of fiduciary duty. *Ramos v. Banner Health*, 461 F.Supp. 3d 1067, 1103 (D. Col. 2020) ("The Court finds it highly significant that Banner has not undertaken a single RFP in nearly 20 years, despite the recognized utility of an RFP for assessing reasonableness of fees.") Plans are more likely to be subject to a suit if the plan has recordkeeping fees on a percentage of assets basis with uncapped revenue sharing.

(2) Monitoring – The plan's investment consultant should regularly monitor investment manager fees, expense ratios, revenue sharing and/or recordkeeper fees and explain to trustees how they are charged.

(3) Review of Each Investment Option – Plans may have investments or menu of options that allows investments (i.e. institutional or retail class shares) with different goals and features that are reviewed at quarterly board meetings to ensure they are appropriate.

(4) Document Selection Process – The selection process of investments or investment options in a trustee-directed plan or participant-directed plan should be documented.