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Supreme Court Set to Tackle Pleading Standard in Northwestern Retirement Plan Lawsuit

PUBLISHED: July 9, 2021

On July 2, 2021, the Supreme Court agreed to hear *Hughes v. Northwestern*, which involves a challenge to investment fees and recordkeeping fees in two 403(b) plans maintained by Northwestern University. The district court dismissed the complaint for failure to adequately plead a breach of the fiduciary duty of prudence, and the Seventh Circuit affirmed the dismissal. The Supreme Court will now weigh in for the first time on the critical issue of what allegations are sufficient to state a plausible breach of fiduciary duty claim for excessive investment and recordkeeping fees. [1]

The Supreme Court will consider the case during its next term, which begins in October 2021, and will likely issue a decision during the first half of 2022.

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Background

Over the last several years, there have been hundreds of class actions brought under ERISA alleging claims for breach of fiduciary duty in connection with the fees of investment options included in 401(k) and 403(b) defined-contribution retirement plans. These "excessive fee" cases often also include allegations regarding the performance of investments and the plan's recordkeeping expenses. At the district court level, court decisions have varied widely on what is sufficient to adequately plead a breach of the duty of prudence with respect to the selection and monitoring of investment options and the reasonableness of plan expenses.

[1] In its 2015 decision in *Tibble v. Edison*, the Supreme Court held that there was a "continuing duty" to monitor investments, but did not address what allegations were sufficient to state a plausible claim.

The plaintiffs in these cases generally ask the court to infer that the plan's fiduciaries did not have a prudent process in place to monitor investments and recordkeeping services because, if they did, the plan would have paid less. Relying largely on publically available information from plans' annual Form 5500s, plaintiffs frequently allege that plans:

- Failed to use the least expensive share class available (e.g., institutional shares);
- Failed to offer index funds in place of more expensive actively managed funds;
- Offered too few or too many investment options;
- Offered investment options that underperformed compared to other funds;
- Paid excessive recordkeeping fees compared to an alleged market-reasonable fee or the fees paid by allegedly comparable plans;
- Paid for recordkeeping as a percentage of plan assets rather than per-participant; and/or
- Failed to regularly issue requests for proposals to consider alternative recordkeepers.

The *Northwestern* case raises many of these theories and, along with a case brought against the University of Pennsylvania, were among a dozen similar lawsuits filed by the same law firm against large universities in 2016. Given the unique history of private university plans, these cases generally involve allegations regarding the use of annuities, numerous investment options and multiple recordkeepers. The district courts in both the *Northwestern* and *Penn* cases granted motions to dismiss. While the Seventh Circuit affirmed the *Northwestern* dismissal in March 2020, the Third Circuit reversed-in-part the *Penn* dismissal in May 2019.

In asking the Supreme Court to hear the *Northwestern* case, the plaintiffs argued that the Seventh Circuit's decision created a circuit split that warranted Supreme Court review. In May 2021, the Biden Administration's Acting Solicitor General, working with the Department of Labor, told the Supreme Court that it should take the case because the *Northwestern* and *Penn* decisions were inconsistent, the issues raised were of significant importance, and "[a]t least two of the [Northwestern plaintiffs'] claims . . . state a plausible claim for breach of ERISA's duty of prudence."

Issues Before the Supreme Court

The Supreme Court will likely address at least the two claims in the case identified by the Solicitor General: not using the lowest-cost share class and failing to take steps to attempt to reduce recordkeeping fees. The Supreme Court may also address other issues, including what allegations regarding investment benchmarks must be included, as well as the relevance of the overall mix of investments offered in the plan, the use of index funds, and revenue sharing. Several of these issues are highlighted below.

Share Classes: The Solicitor General took the position that the plaintiffs had stated a claim by alleging that the plan fiduciaries knew or should have known that there were identical lower-cost share classes available to large plans, and that similarly-situated fiduciaries had negotiated for less expensive share classes. Lower courts disagree over whether not using the lowest-cost share class, standing alone, states a claim. Moreover, plan fiduciaries sometimes include higher-cost share classes if those share classes provide revenue-sharing to the plan to cover expenses like recordkeeping fees. Although the Supreme Court held in its landmark decision in *Bell Atlantic v. Twombly* that conduct which is "in line with a wide swath of rational . . . business strategy" could not be the basis for inferring wrongdoing, the Third Circuit in *Penn* held that principle did not apply to ERISA breach of fiduciary duty cases.

Implications of Broad Array of Investment Options: The Solicitor General also took issue with the Seventh Circuit's determination that the plaintiffs failed to state a claim that the plans improperly included higher-cost funds over cheaper index funds because the plans offered a broad array of investment options with varying expense ratios, including index funds. The Seventh Circuit reasoned that the wide array of investment options allowed plan participants to choose cheaper index funds. The Solicitor General argued that each individual investment option should be assessed independently, and that offering a broad array of investment options with varying expenses does not excuse the inclusion of imprudent investment options.

Investment Benchmarks: The Supreme Court may also clarify the standard for analyzing an appropriate "benchmark" for challenged investments at the motion to dismiss stage. As the Solicitor General acknowledged, most courts hold that – at least outside of the share class context – a plaintiff cannot state a claim merely by alleging that a less expensive or better performing alternative investment option exists. Nevertheless, some courts have declined to address what constitutes an appropriate benchmark comparison for a particular investment at the motion to dismiss stage, functionally giving plaintiffs a free pass on the issue.

Recordkeeping Fees: The Solicitor General took the position that the plaintiffs had stated a claim by alleging that the plan fiduciaries could have reduced recordkeeping fees by negotiating for lower fees, conducting a competitive bidding process, or using one recordkeeper instead of two. In particular, the Solicitor General explained that these allegations allowed an inference that "a reasonable plan fiduciary would have monitored the recordkeeping fees . . . and attempted to reduce them without experiencing diminished services." Many complaints allege few, if any, facts about the quality of services that would be available under an alternative cheaper recordkeeping arrangement – and lower courts are currently in disagreement of whether such allegations are necessary to survive a motion to dismiss. Additionally, while most courts recognize that there is no requirement to issue requests for proposal for recordkeeping services, others have recited such allegations as a reason to deny a motion to dismiss.

Conclusion

Lawsuits challenging the fees and investment options in the 401(k) and 403(b) context have had varying results at the pleading stage. The Supreme Court's decision in the *Northwestern* case could bring some degree of clarity and uniformity to the pleading standard for breach of fiduciary duty allegations related to plan expenses and investment options. The impact of the Supreme Court's intervention on this issue will largely depend upon the pleading standard it ultimately adopts.