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Sixth Circuit Addresses Key Issues in Excessive Fee Lawsuits

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On June 21, 2022, the Sixth Circuit in *Smith v. CommonSpirit Health* unanimously affirmed the decision of the Eastern District of Kentucky dismissing with prejudice a putative class representative's ERISA fiduciary breach claims based on the investment options and administrative fees of CommonSpirit Health's 401(k) plan. Groom Law Group represented CommonSpirit Health and its retirement plan committee ("CommonSpirit") in the lawsuit and on the appeal. The Sixth Circuit's published decision is a major development in the landscape of litigation challenging the investment options and recordkeeping fees in 401(k) plans. *Smith* is the first published Court of Appeals decision to articulate the governing standards for evaluating ERISA imprudence claims at the pleading stage after the Supreme Court's recent decision in *Hughes v. Northwestern University*.

In *Smith*, the Sixth Circuit addressed several major issues arising out of excessive fee litigation, including (1) whether it is imprudent to offer actively managed funds in a 401(k) plan; (2) whether passively managed funds are meaningful benchmarks for actively managed funds with respect to performance or fees; (3) the extent to which circumstantial allegations of fund underperformance can support an inference that a fiduciary acted imprudently; and (4) the extent to which allegations of excessive recordkeeping and investment management fees can support an inference of imprudence based on purported industry averages. As discussed further below, the Sixth Circuit decided each of these issues favorably to CommonSpirit.

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Background

In recent years, there have been hundreds of class actions brought under ERISA alleging claims for breach of fiduciary duty in connection with the fees and performance of investment options included in

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401(k) and 403(b) defined-contribution retirement plans. These "excessive fee" cases often also include allegations regarding the plan's recordkeeping expenses.

Smith is one of dozens of cases filed since 2020 that specifically target the inclusion of the Fidelity Freedom Funds in 401(k) plans. The centerpiece of the Freedom Fund lawsuits, which have been filed by plaintiffs across the country, is the allegation that the defendant plan sponsor and plan fiduciaries should have replaced the actively managed Freedom Funds with the passively managed Fidelity Freedom Index Funds. While actively managed funds use fund managers to buy and sell stocks in an effort to outperform a specific index, passively managed funds track an established market index and the fund manager does not make any independent investment choices. As a result, passively managed funds tend to be less expensive than actively managed funds.

The plaintiff in *Smith* claimed that CommonSpirit breached fiduciary duties under ERISA by including the Freedom Funds and certain other actively managed investment options in CommonSpirit's 401(k) plan that allegedly underperformed and charged excessive fees. The plaintiff also claimed that CommonSpirit breached fiduciary duties under ERISA by allowing the plan to pay excessive recordkeeping and plan-wide investment management fees.

The district court rejected each of the plaintiff's claims, dismissing them with prejudice. As to the plaintiff's imprudence claims concerning the plan's inclusion of the Freedom Funds and other challenged investments in the plan, the district court held that actively and passively managed funds cannot be meaningfully compared, in part due to their different investment strategies. In addition, the district court held that the plaintiff failed to plausibly allege substantial underperformance by any of the challenged investments, noting that the Freedom Funds actually *outperformed* the Freedom Index Funds that the plaintiff preferred. As to the plaintiff's claims challenging the plan's allegedly excessive recordkeeping and plan-wide investment management fees, the district court held that generalized allegations that the plan's fees fell below industry averages were insufficient to sustain plausible fiduciary breach claims.

The Sixth Circuit's Opinion

In its opinion affirming the district court's ruling, the Sixth Circuit began by articulating the pleading standard for breach of ERISA's duty of prudence. The Sixth Circuit explained that ERISA "does not give the federal courts a broad license to second-guess the investment decisions of retirement plans." Rather, the court emphasized that lower courts must carefully scrutinize a complaint's allegations at the pleading stage. Quoting from the Supreme Court's recent decision in *Hughes v. Northwestern*, the Sixth Circuit stated that "courts must give due regard to the range of reasonable judgments a fiduciary may make based on her experience and expertise."

The Sixth Circuit went on to hold that CommonSpirit did not breach its ERISA fiduciary duties in offering actively managed Freedom Funds over the passively managed Freedom Index Funds, which plaintiff alleged were better-performing and less expensive.

First, the Sixth Circuit affirmed the district court's ruling that the plaintiff could not state a plausible claim that the plan fiduciaries imprudently offered actively managed funds when passively managed index funds were available. The Sixth Circuit agreed with the district court that active and passive

funds have "distinct goals and distinct strategies, making them inapt comparators." The court observed that because each plan participant "has a distinct risk profile," it is prudent for plans "to offer a range of reasonable investment options, including passive and active funds." Indeed, the Court observed that a plan's *failure* to offer "any actively managed funds suited for risk-tolerant investors" could be imprudent.

Second, the Sixth Circuit affirmed the dismissal of the plaintiff's claims that the Freedom Funds and other challenged funds underperformed. The court found that the plaintiff failed to make plausible allegations that any of the funds "was imprudent from the moment the administrator selected it, that the investment became imprudent over time, or that the investment was otherwise clearly unsuitable for the goals of the fund based on ongoing performance." The court reasoned that simply pointing to an investment option that has performed better over a short period of time "does not suffice to plausibly plead an imprudent decision—largely a process-based inquiry—that breaches a fiduciary duty." The Court further explained that while a fund's underperformance against a meaningful benchmark "may offer a building block for a claim of imprudence," it cannot by itself support an imprudence claim, "especially if the different performance rates between the funds may be explained by a different investment strategy." The court also pointed out that equating short-term losses with imprudent investment choices "is one of the surest ways to frustrate the long-term growth of a retirement plan," and that holding otherwise would mean that "every actively managed fund with below-average results over the most recent five-year period would create a plausible ERISA violation." With respect to the Freedom Funds, the Sixth Circuit also discounted the plaintiff's allegations of other purported "red flags," including alleged outflows from the Freedom Funds and outside analysts' "critical" evaluations of the funds. The Sixth Circuit pointed to the enduring popularity of the Freedom Funds in the marketplace and the district court's finding that the Freedom Funds *outperformed* the Freedom Index Funds in the most recent performance data.

Third, the Sixth Circuit rejected the plaintiff's challenge to the plan's recordkeeping fees. The court found that the plaintiff failed "to allege that the fees were excessive relative to the services rendered," or any facts "concerning other factors relevant to determining whether a fee was excessive under the circumstances." The court noted the plaintiff's comparison of CommonSpirit's fees to those of "some of the smallest plans on the market" reflected in industry publications was inapt, given that those plans "might offer fewer services and tools to plan participants."

Fourth, the Sixth Circuit affirmed the dismissal of plaintiff's claim that the average investment management fee for all funds in the plan's lineup was too high. The court noted that "actively managed funds need to charge higher fees, because they must hire management teams to actively select investments to buy and sell, whereas index funds require less management and less upkeep." The court concluded that the average plan-wide management fee is "merely evidence that CommonSpirit offers a number of actively managed funds" and could not, without more, sustain an imprudence claim.

Finally, the Court dismissed the plaintiff's remaining claims alleging breach of the duty of loyalty, failure to monitor fiduciaries, co-fiduciary-liability, and knowing breach of trust, because these claims were duplicative of the plaintiff's other claims or otherwise were not viable.

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Key Takeaways

The Sixth Circuit's ruling in *Smith* is a significant defense-side victory in the flood of litigation involving excessive fee claims against 401(k) plans and their fiduciaries. *Smith* is the first published Court of Appeals decision addressing the pleading standard for breach of ERISA's duty of prudence since the Supreme Court's ruling in *Hughes v. Northwestern*. Earlier this year, following *Hughes*, the Ninth Circuit issued two unpublished decisions reviving excessive fee lawsuits brought against Trader Joe's and Salesforce Inc. However, both decisions were short and offered little analysis of the pleading standard for imprudence claims. In contrast, the Sixth Circuit in *Smith* provides detailed guidance on how district courts should scrutinize excessive fee complaints, particularly those involving allegations of fund underperformance, comparisons between actively and passively managed funds, and allegations of excessive recordkeeping and investment management fees. Defendants facing excessive fee lawsuits will undoubtedly rely on *Smith* going forward as support for dismissing claims against them.

Smith may also bear on excessive fee cases pending in other circuit courts. Although the current wave of excessive fee litigation is not expected to subside anytime soon, the *Smith* decision should help both defendants and district courts to dispose of meritless claims at the motion to dismiss stage.

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