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View From Groom: The University Fee Cases—Product of the Past, Possible Wave of the Future

BY DAVID POWELL AND MARK BIETER

This August, when students around the country were beginning to focus on school, there was a hurricane of legal activity also focused on schools: Within a matter of days, the plaintiffs firm Schlichter, Bogard & Denton filed twelve class action lawsuits in multiple U.S. district courts against private universities claiming they had breached ERISA fiduciary duties owed to participants in their retirement plans.

The suits resemble the dozens of ''excessive fee'' class actions that Schlichter and other firms have pursued against 401(k) plan sponsors and fiduciaries in recent years. But they are novel in many respects, especially because their targets, the fiduciaries of 403(b) retirement plans, have not been the focus of much ERISA fiduciary breach litigation until now. The new cases will test the essential structure of such plans, which has been in place for decades, and will determine whether fiduciary standards developing in 401(k) matters should be applied in the same manner in the 403(b) context. And they may represent the next frontier in fee litigation, with significant implications for plan sponsors, fiduciaries, participants, and the financial industry.

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The Lawsuits' Allegations

The defendants in the suits are twelve private universities, thus subject to ERISA, and, in many cases, plan committees, individual committee members, or administrators, who are alleged to have fiduciary obligations in relation to the universities' retirement plans. With one exception not analyzed here, all the suits involve 403(b) retirement plans, which under the Internal Revenue Code allow tax-deferred contributions for employees of educational and charitable organizations, either through employer funding or employees' voluntary salary reduction contributions. The plans at issue have assets ranging from about $2.2 to $4.7 billion and tens of thousands of participants, which according to the complaints ranks them in the top 1 percent of all defined contribution plans in the nation. No public higher education 403(b) plans have been sued, presumably because they are generally not subject to ERISA.

The plaintiffs in each case seek to represent a class of all participants and beneficiaries in the plans from a date exactly six years before the filing of the complaint, a timeframe aimed at complying with ERISA's limitations period. Generally, the complaints allege that the plans' fiduciaries violated ERISA obligations and caused losses to participants by (1) offering large, complex investment lineups with options that were expensive, duplicative, and poorly performing, and (2) engaging multiple plan recordkeepers without a competitive bidding process, causing the participants to pay high administrative fees.

Besides challenging the number of investment options included in the plans, the plaintiffs allege that those options—including annuities, mutual funds, and separate accounts—carried higher costs than others available in the marketplace to large plans, which they claim can leverage their size to obtain lower fees. The plaintiffs identify a number of alleged failures by the defendants that led to the excessive fees.

First, the complaints claim that plan fiduciaries chose a ''dizzying array of duplicative'' share classes, eliminating the bargaining power that they say accompanies accumulation of assets into a single share class. The selection of such large numbers of investment options, which numbered in the hundreds in some cases, not

only allegedly caused higher fees but also led to ''decision paralysis'' for participants, creating unnecessary complexity in investment lineups that plaintiffs claim should only include around 15 options.

Second, the defendants allegedly failed to select the lowest-cost share class available and often included retail share classes that had much higher fees than institutional classes.

Third, the plaintiffs allege the plans' fees were excessive because defendants chose actively managed rather than passively managed index funds.

Finally, the lawsuits claim that administrative fees were expensive because the defendants engaged multiple recordkeepers without adequately investigating and negotiating in the ''highly competitive'' market for such services. They allege that consolidating to a single recordkeeper would have been more efficient and lowered administrative fees. The plan fiduciaries, they say, should have conducted a competitive bidding process about every three years to ensure that fees were reasonable.

Moreover, plaintiffs challenge revenue sharing payments the service providers received based on a percentage of assets invested in each investment option, which they allege can effectively be ''kickbacks to induce recordkeepers to use higher-cost share classes.'' The plaintiffs claim that the recordkeeping fees should have been on a per-participant basis, not based on a percentage of plan assets, because as plans grew over time, revenue sharing amounts also grew and became unreasonable compared to the services provided.

Besides causing the plan participants to pay excessive fees, plaintiffs claim, the defendants breached their fiduciary duties by retaining ''historically underperforming funds'' that should have been replaced by more successful options. The plaintiffs single out a number of individual investment options that they say were outperformed by models the plaintiffs picked.

The complaints include the same three counts: (1) breach of ERISA fiduciary duties of loyalty and prudence due to unreasonable administrative fees; (2) breach of those ERISA fiduciary duties through unreasonable investment management fees and performance losses; and (3) failure to monitor fiduciaries.

Besides seeking class certification, the plaintiffs request relief in the form of declarations that the defendants breached their fiduciary duties; findings that the defendants are personally liable to make good to the plans all losses resulting from those breaches; accountings; removal of fiduciaries and enjoining them from future ERISA violations; surcharges; requiring the fiduciaries to obtain bids for recordkeeping, ''to pay only reasonable recordkeeping expenses,'' and to ''include only prudent investments''; attorneys' fees and costs; and other equitable relief.

Each complaint includes a jury demand, which have become more common in recent excessive fee cases. Traditionally, courts have held that the monetary relief sought in ERISA cases was equitable in nature, not legal, and therefore courts have struck jury demands in such matters. In recent years, however, plaintiffs' firms have been seeking jury trials more frequently in ERISA excessive fee suits, usually relying on a line of Supreme Court cases (including *Great-West* and *Mertens*) to argue that the requested monetary relief is purely legal in nature, and therefore a jury trial is appropriate.

The Background of 403(b) Plans

In some respects, the university lawsuits could be considered the final stage in a hundred-year evolution of their retirement plans, which started with loose arrangements that were not ''plans'' at all but ''programs'' in which teachers saved for retirement on an individual basis, and gradually became more formal structures governed by ERISA and other statutes. That universities would be the targets of litigation challenging the governance of their retirement plans was barely conceivable just a decade ago.

The foundation for such plans began in the early 1900s, around the time retirement plans were beginning to blossom in the United States, when the Carnegie Foundation for Advancement of Teaching helped lead to the creation of pensions for college professors. In 1942, the U.S. income tax laws recognized the tax exemption of employer university contributions to employees' retirement, which were typically funded through individual annuity contracts owned by the employees. In essence, those annuities were fully portable pensions. This arrangement, which lasted for many decades, created an atmosphere where there was significant individual autonomy by employees and little oversight or administration by employers. The universities opened their campuses to multiple vendors in order to expand options for employees, who therefore had significant say over which product and service providers helped meet their retirement goals. It was typical, as an example, for annuity providers to meet directly with employees and assist in establishing their accounts, with little or no participation by the employers. The system operated much like modern-day Individual Retirement Accounts (IRAs), in this case for teachers and other university employees.

This diffuse structure continued even after IRC section 403(b) was enacted in 1958 to limit the amounts that university employees could contribute to annuities, which were still the only investment option available to university employees at the time. It continued even after ERISA was enacted in 1974, and it was reinforced when the Department of Labor issued ERISA regulations several years later. The DOL, recognizing that many private sector 403(b) retirement programs did not have significant employer involvement, created a ''safe harbor'' for them in the regulations, similar to the safe harbor for an employer to avoid establishing a plan when it made available salary reduction contributions to an IRA: A plan with little employer involvement, including very little employer administration, that consisted solely of salary reduction contributions, and with constraints on the ability of the employer to limit the products or contractors available to employees, would generally not be considered an employer-sponsored ''plan'' subject to ERISA.

Over time, however, subsequent tax legislation including the Economic Growth and Tax Relief and Reconciliation Act of 2001 added provisions that made 403(b) ''programs'' act more like other qualified ''plans,'' particularly 401(k) plans. That evolution accelerated in 2007, when newly proposed IRS regulations first began to force 403(b) programs to operate less like loose collections of individual accounts and more like centralized entities that had the essential characteristics of ERISA ''plans.'' Most notably, the new IRS 403(b) regulations made university and non-profit em-

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ployers responsible for gathering annuity contracts together—in effect, to ''administer'' their 403(b) plans. The employer could delegate that administration to another party, such as a third-party service provider, but it could not delegate it to the participants, in effect overturning a system that had been in place for almost a century.

The sea-change of the IRS regulations was the impetus then for further DOL guidance on the 403(b) safe harbor regulations. In 2007, the DOL issued Field Assistance Bulletin 2007-2, which set forth the DOL's views on the conditions for the ERISA safe harbor that were perceived as tightening its availability, though the DOL might characterize them as just further explanation. In any event, the new guidance caused many sponsors to elect to bring their former 403(b) ''programs'' into ERISA.

Although the legal conditions for 403(b) retirement plans changed, the unique attributes and features of 403(b) retirement plans remained in place. Teachers and other university employees have long been accustomed to autonomy over their retirement objectives, including significant influence over selection of plan service and product providers, and they are also used to having a large variety of choices. Moreover, many university employees genuinely like the products they were offered, including fixed and variable annuity contracts that are essential features of 403(b) plans, and also the vendors known for understanding the needs of teachers.

The new lawsuits could present a challenge to this tradition, particularly if university plan sponsors and fiduciaries overhaul their plan structures in response to legal risks. Many already have. Several of the defendant universities, for example, have revised their plans significantly in recent years, reducing the number of investment options to fewer than 20 and consolidating to a single recordkeeper. The plaintiffs sued those universities anyway, alleging that if they had made the changes faster, participants ''would have avoided paying millions of dollars in unreasonable investment and administrative fees, and millions of dollars in performance losses.'' In fact, the plaintiffs highlighted communications those universities issued to participants about the changes, claiming they only show the defendants ''have admitted that the Plans' prior structure was imprudent.'' Of note and possible hope to the universities being targeted, at the same time these lawsuits were filed, many of the same theories espoused by plaintiffs were squarely rejected in a Northern District of California District Court decision in private sector litigation involving Chevron's 401(k) plan brought by this same firm.

Some Questions the Cases May Answer

The university fee cases present a number of novel questions. The outcomes may provide some answers.

For example, given the background and structure of 403(b) plans, can the plan fiduciaries be considered to have violated ERISA duties of prudence and loyalty? Among other requirements, ERISA fiduciaries are expected to discharge their duties ''with the care, skill, prudence, and diligence *under the circumstances then prevailing* that a prudent [person] acting in a like capacity and familiar with such matters would use.'' The defendants can reasonably argue that university employees preferred the kind of individual control that had been fundamental to their plans for decades, including the ability to choose from a wide variety of investment choices and multiple providers. From that perspective, the plan fiduciaries could be seen to have acted prudently, simply giving the participants what they wanted. At a basic level, these cases will address whether fiduciary standards that have been promoted in the 401(k) plan litigation context via conclusory statements from the plaintiffs' bar with limited legal authority can necessarily be applied to 403(b) plans.

Closely related, the fiduciaries' obligations in these cases will have to be considered in a context in which annuities have long been a fundamental element. In fact, for decades annuities were the *only* investment options allowed to 403(b) retirement programs, and the IRC did not permit mutual funds in 403(b) lineups until section 403(b) was amended by ERISA in the 1970s. Moreover, the legacy annuity contracts are often between the provider and the participant, not the plan sponsor, and in many cases by their terms cannot be removed as plan investment options as easily or quickly as the complaints suggest. The plaintiffs' bar regularly asserts that annuities are ''per se'' improper because of a sole factor: costs. Judge Hamilton notably stated in her decision in *White v. Chevron Corp*. earlier this year, though, that ERISA plan fiduciaries ''have latitude to value investment features other than price.''

The cases will also wrestle with the question of whether 403(b) plan fiduciaries' retention of more than one recordkeeper complies with ERISA fiduciary standards. Although plaintiffs challenge the structure as a major reason for higher fees, defendants could respond that engaging multiple recordkeepers ultimately creates more efficient and better services, given the variety of investment vehicles in 403(b) plans. And again, defendants might argue that they were complying with the participants' preferences. Of course, the plaintiffs seem likely to stick to their single theme—minimum cost—rather than the full range of fiduciary concerns applicable under ERISA.

How such questions are resolved will likely determine whether these initial cases are followed by an avalanche of more lawsuits or by a disinterested fizzle due to failure. Regardless, their outcomes will probably influence decisions by schools, non-profits, plan fiduciaries, and financial services and product providers for many years to come.