Class action lawsuits alleging fiduciary breaches have been filed in the last two years against 16 private universities with regard to their Section 403(b) plans. The authors explain the implications of these lawsuits for defined contribution plan sponsors.

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# THE UNIVERSE OF THE UNIVERSITY CASES:

## A New Approach to ERISA Enforcement

In the past two years, 16 prominent private universities have found themselves faced with class action lawsuits brought under the Employee Retirement Income Security Act of 1974 (ERISA). In each lawsuit, the plaintiffs assert that an Internal Revenue Code Section 403(b) plan fiduciary breached its duties under ERISA because it failed to use its alleged "tremendous bargaining power" to seek low-cost administrative and investment management services.

Plaintiffs have alleged that universities offered funds that are too expensive. They also have claimed that plan fiduciaries were asleep at the switch, failing to offer lowest cost share classes or failing to monitor and remove underperforming funds. All of the cases present the same basic question—Would a prudent and attentive fiduciary, when faced with the same reasonably available information, have acted differently under the circumstances?

With the exception of one suit that has been completely dismissed,[1] the others remain pending. Given the breadth of the allegations—each complaint generally refers to "defined contribution plans" and relies heavily on allegations derived from Section 401(k) lawsuits—the university cases have the potential to mandate legal behavioral standards not just for sponsors of retirement plans qualified under Section 403(b) but for all large defined contribution plans governed by ERISA.

## The Origin of the 403(b) Plan

Congress added Section 403(b) to the Internal Revenue Code in 1958 to curb the practice of Section 501(c)(3) organization employees diverting most—in some cases all—of their compensation to tax-sheltered annuities. Section 403(b) formally recognized the tax-sheltered annuity retirement concept, requiring that all employees—from a physician to a janitor—be offered the opportunity to invest in tax-favored annuities up to an annual "exclusion allowance" that limited the amount of compensation an employee could set aside on a tax-favored basis.

In addition to universities, 403(b) plans are offered by many other nonprofit organizations such as hospital systems.

Unlike 401(k) plans, 403(b) plans experienced limited regulation and reporting obligations until the 2009 plan year. Congress added mutual fund shares as a permitted 403(b) plan investment option in 1974, the same year that it introduced the private sector 401(k) plan. Rather than limiting investment options to a particular menu, however, most 403(b) plans accumulated hundreds of investment options and recordkeepers by offering each participant the ability to invest with the annuity or mutual fund provider of his or her choice. The 2009 plan year was the first in which Congress required 403(b) plans to follow a written plan document and adhere to ERISA annual disclosure obligations. Owing in part to pressure from litigation, many 403(b) plan sponsors have since begun consolidating investment options and recordkeepers.

While the origins of 403(b) plans differ from 401(k) plans, the university cases analyze fiduciary duty questions based on a nearly identical analysis to lawsuits brought against 401(k) plans: Circumstantial evidence of fiduciary breach under ERISA exists wherever a "billion dollar defined contribution plan" failed to use its "tremendous bargaining power" to reduce administrative or investment fees. However, attempting to apply the same arguments in 401(k) plan claims to 403(b) plans ignores these historical differences between the two types of plans.

## The Evolving ERISA Litigation Landscape

To enforce the various fiduciary duties and to address potential prohibited transactions, ERISA authorizes the Department of Labor (DOL), plan participants, plan beneficiaries and plan co-fiduciaries to bring civil actions in federal court. These actions under ERISA Section 502(a) allow enumerated plaintiffs to (1) recover losses on a planwide basis, (2) restore benefits personally due to a participant or beneficiaries (or allegedly due to an assignee of a claim to enforce a vested benefit due to a participant or beneficiary) or (3) to obtain "other appropriate equitable relief" to enforce ERISA.

Because ERISA fiduciary duties are meant to provide high standards for the protections and management of employee benefits, an ERISA fiduciary that breaches his or her fiduciary duties can be (a) held personally liable for all losses suffered by the plan, (b) required to return profits obtained through the improper use of plan assets and (c) held liable for other remedial and equitable relief deemed appropriate by a court.

In recent years, there has been a dramatic rise in the number of theories that plaintiffs' attorneys, DOL and disgruntled participants bring in ERISA litigation. The shift of the market toward individual control in participantdirected 403(b) plans—so called ERISA 404(c) plans—has been accompanied by a dramatic increase in the variety and complexity of financial products and investment options. ERISA 404(c) provides a safe harbor for investment losses that are attributable to participant investment decisions, so long as the fiduciary satisfies specific steps. These steps include providing adequate disclosure of fees and expenses, as well as offering a sufficient range of investment options such that participants have control over the risk of loss.

While refusing to issue a ruling on whether it is a fiduciary breach for a sponsor to offer retail classes of mutual fund shares when less expensive institutional classes are available, the 2015 Supreme Court opinion in *Tibble v. Edison International* affirmed that a fiduciary of an ERISA 404(c) plan has an ongoing duty—separate and apart from its initial duty to select prudent investments—to monitor and remove imprudent trust investments.[2]

Coming not long after *Tibble,* the $62 million settlement in *Abbott v. Lockheed Martin Corp.* opened the floodgates to large-scale ERISA class action litigation. Originally filed in 2006, the plaintiffs in *Lockheed Martin* alleged that a 401(k) plan sponsor breaches its fiduciary duties when it (1) offers money market investments when other, higher yielding, stable value fund options are available; (2) offers investments with high expense ratios; or (3) permits participants to be charged excessive recordkeeping fees. The complaint in *Lockheed Martin* also included an allegation that prohibited transactions and/or breaches of loyalty result when plan service providers are selected that have some relationship to the plan fiduciary.

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## Do Plans Have the Fiduciary Obligation to Bargain Hunt?

There are generally two primary costs associated with both 403(b) plans and 401(k) plans: (1) recordkeeping (plan administration) costs and (2) investment management costs. The underpinning of the university cases is the idea that a large plan breaches its fiduciary duties under ERISA in various ways when it does not use its economy of scale to negotiate favorable terms in its investment or recordkeeping agreements or, at minimum, conduct periodic requests for proposals (RFPs) to monitor whether the fees it is being charged are comparable with other plans.

ERISA indeed requires diversification of investments and encourages participant choice; however, the university cases challenge the idea that ERISA allows universities (a highly specific group of plan sponsors) to, in reasonable circumstances, give their participants a choice regarding how active they want to be in managing their 403(b) plan retirement accounts. These claims, also seen in the context of 401(k) plans, challenge the prudence of offering certain types, classes or numbers of investment options.

The fiduciary duties in ERISA are written specifically to reflect an evolving standard, so there is not a specific legal standard for recordkeeping or investment fees for 403(b) plan services beyond that the fees be reasonable. In some university cases, the plaintiffs claim that fees paid by participants (either asset-based or flat per capita fees) were significantly higher than those available in the marketplace. Generally, the claim that a plan could have negotiated a more favorable arrangement is speculation. In addition, minimizing fees is just one factor a fiduciary must consider in deciding whether to consolidate investment options or recordkeeping platforms in its 403(b) plan.

Because the appropriate fee structure for an ERISA-governed plan is a fiduciary decision, the bare allegation that paying a flat amount for recordkeeping is preferable to paying a percentage of assets is purely an opinion. Best practices call for plan sponsors to consider and compare asset-based fees and flat fees, as well as the viability of a nondiscriminatory rebate of revenue-sharing funds back to participants. Asset-based fees generally require that participants pay a pro-rata percentage of recordkeeping costs based on their investments, meaning that those participants with higher account balances pay more than those with lower balances. Flat fees, however, may disadvantage lower paid participants, who tend to maintain lower account balances.

In the only new and unique allegation in the 403(b) plan context, several university cases initially argued that the 403(b) plan convention of offering hundreds of investment options results in participant confusion and decision paralysis. Three courts have already dismissed this allegation at the pleading stage.

Particularly troubling for fiduciaries, these lawsuits take advantage of the ERISA fiduciary framework to seek settlement, essentially arguing that any act or omission constitutes a fiduciary breach, even if no identifiable damages result. Some claims state that fiduciaries should have offered passive funds instead of more expensive, actively managed funds. Others argue that institutional funds should be offered instead of more expensive retail funds. A number of lawsuits claim that the fiduciary should have offered a stable value fund when only a money market fund was available. Ironically, the reverse claim also has been asserted.

## Board Members With Conflicts—Prohibited Transaction Potential

In a lawsuit filed against the Massachusetts Institute of Technology (MIT), the plaintiff claims that the fiduciaries improperly influenced the selection of the plan's third-party administrator (TPA) because (1) MIT did other business with the TPA, (2) the chief executive officer of the TPA was on the MIT board and (3) the TPA had donated $200,000 to MIT.[3] This alleged situation reflects an unfortunate but not an altogether unusual fact pattern—A letter obtained by the plaintiff in that lawsuit celebrates the plan's move to the provider and notes that the provider was well-known to MIT because MIT had done other business with it. In some situations, members of the board of directors or board of trustees should be mindful that they may share fiduciary status, at least for monitoring responsibilities, when board of directors committees are responsible for selecting 403(b) plan investments or TPAs for Section 403(b) plans. Committees generally have authority that is delegated from the board level.

## ERISA Preemption

ERISA has the broadest preemptive authority of all statutes in the U.S. Internal Revenue Code. In an effort to respond to these lawsuits, many plan sponsors seek to remove the case to federal district court because of the perception that federal judges are more familiar with these types of issues. However, it should be noted that the broad preemption language in ERISA has produced a confusing and complex body of case law.

Generally speaking, ERISA preempts any state law that "relates to" rights under an ERISA-governed employee benefit plan. It also preempts state laws that are "duplicative" of rights or causes of action under ERISA. There are narrow exceptions for state insurance, banking and securities laws. However, ERISA removes any plan assets from state-level authority by providing that no employee benefit plan shall be deemed to be an insurance company or other insurer, bank, trust company or investment company for the purpose of state regulation.

Not surprisingly, plaintiffs often attempt to circumvent ERISA through claims in state court because state law claims sometimes provide avenues for additional relief. The ability to successfully bring a claim outside of ERISA is contingent on the plaintiff finding some "hook" that the claim is not a product of the administration of the plan. Developing a game plan to knock out—and reclassify—these disguised ERISA claims at the outset is often key.

## takeaways

- The class action lawsuits filed against 16 prominent private universities have alleged that the universities breached their fiduciary duties by failing to use their bargaining power to seek low-cost administrative and investment management services for their Section 403(b) plans.
- Unlike 401(k) plans, 403(b) plans experienced limited regulation and reporting obligations until the 2009 plan year, when Congress required the 403(b) plans to follow a written plan document and adhere to Employee Retirement Income Security Act (ERISA) annual disclosure obligations.
- Administrators of 403(b) plans—typically retirement committees—should meet regularly to keep apprised of the operations of the plan and retain written record of large-dollar decisions that affect a large number of plan participants.
- If lower cost investments are available but not offered in a 403(b) plan, fiduciaries should document the reason.
- If selected investment funds generate revenue-sharing payments, fiduciaries should consider and document why an offered fund is preferable to a similar fund that does not contain revenue sharing.

## Implications for Plan Sponsors

The biggest lesson to be learned from the university cases is the importance of a 403(b) plan administrator meeting regularly to keep apprised of the operations of the plan. At prominent universities, plan administrators often take the form of retirement committees, and individual members are generally appointed by the university board of trustees. The retirement committees must keep good minutes and should prepare a written record that is sufficient to demonstrate a deliberative and thoughtful decision-making process. These committees should retain memoranda for large-dollar decisions and decisions that affect—or have the reasonable potential to affect—a large number of plan participants and/or highly compensated participants.

If lower cost funds are available but not offered, the law expects that a plan fiduciary document the reason (e.g., less disruption to plan participants, better return on participant investment, etc.). Particularly in cases in which selected investment funds generate revenue-sharing payments, fiduciaries should consider and document why an offered fund is preferable to a similar fund that does not contain revenue sharing.

Older 403(b) plans should periodically assess the appropriateness of continuing to offer annuity products or providers. In some situations, annuity products offer advantages that can outweigh pricing and restrictions. Disadvantages can be that providers often do not permit portability, which means the accounts cannot be transferred to other investment options and must be frozen until a participant reaches a distribution event like retirement.

It is getting more and more important to have and monitor a written investment policy statement (IPS). An IPS typically includes a description of the types of investment funds to be offered to 403(b) plan participants and beneficiaries. An IPS may also prescribe benchmarks against which to compare the performance of the 403(b) plan investment options. A fiduciary must understand the features of the investment products offered, and an IPS can often prescribe factors fiduciaries must consider. In most situations, committee minutes should frequently refer to the IPS and how decisions align with it. Though independent advisors cannot relieve a fiduciary of its fiduciary duties, independent advisors and delegates often assist ERISA fiduciaries and can provide objective evidence of a fiduciary's good faith. It often behooves a fiduciary to outsource a review of each plan fund on a periodic basis and be ready to act outside of regularly scheduled meetings in extenuating circumstances.

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## Endnotes

1. *Sweda et al. v. University of Pennsylvania et al.* (E.D.Pa.), dismissed September 21, 2017.
2. *Tibble et al. v. Edison International et al.*, 135 S.Ct. 1823 (May 17, 2015).
3. *Tracey et al. v. Massachusetts Institute of Technology et al.* (D.Mass.).