SAGE VIEW

ERISA Litigation in Defined Contribution Plans: Background, History, Current Status and Risk Management Techniques

Jon Chambers, CPFA
Managing Director

March 2021

INTRODUCTION

Over the past fifteen years, ERISA fiduciary litigation in defined contribution plans has grown from a rare event, where any material lawsuit filed against a plan sponsor triggered numerous news stories and many presentations and conversations at retirement industry conferences, to a seemingly everyday occurrence, where fiduciary liability insurance underwriters Euclid Specialty report that claims are so commonplace that fiduciary liability insurance may disappear. “Insurance companies have paid well over one billion in settlements, but this economic model cannot continue. We have reached an inflection point in the war against defined contribution plans because the risk has become virtually uninsurable.” Euclid reports that over 200 cookie-cutter ERISA class action lawsuits have been filed since 2015, with over 90 cases filed in 2020 alone.

How did we get to a point where the simple act of sponsoring a defined contribution retirement program exposes plan sponsors to potentially uninsurable litigation risks? And perhaps more importantly, how can plan sponsors protect themselves against the risks associated with their plans – namely, litigation risk, through minimizing the chance that they will be named as a defendant in one of these lawsuits, and also insurability risk, as fiduciary liability insurance providers increasingly move to reduce coverage limits, materially increase retention, or perhaps even cancel coverage?

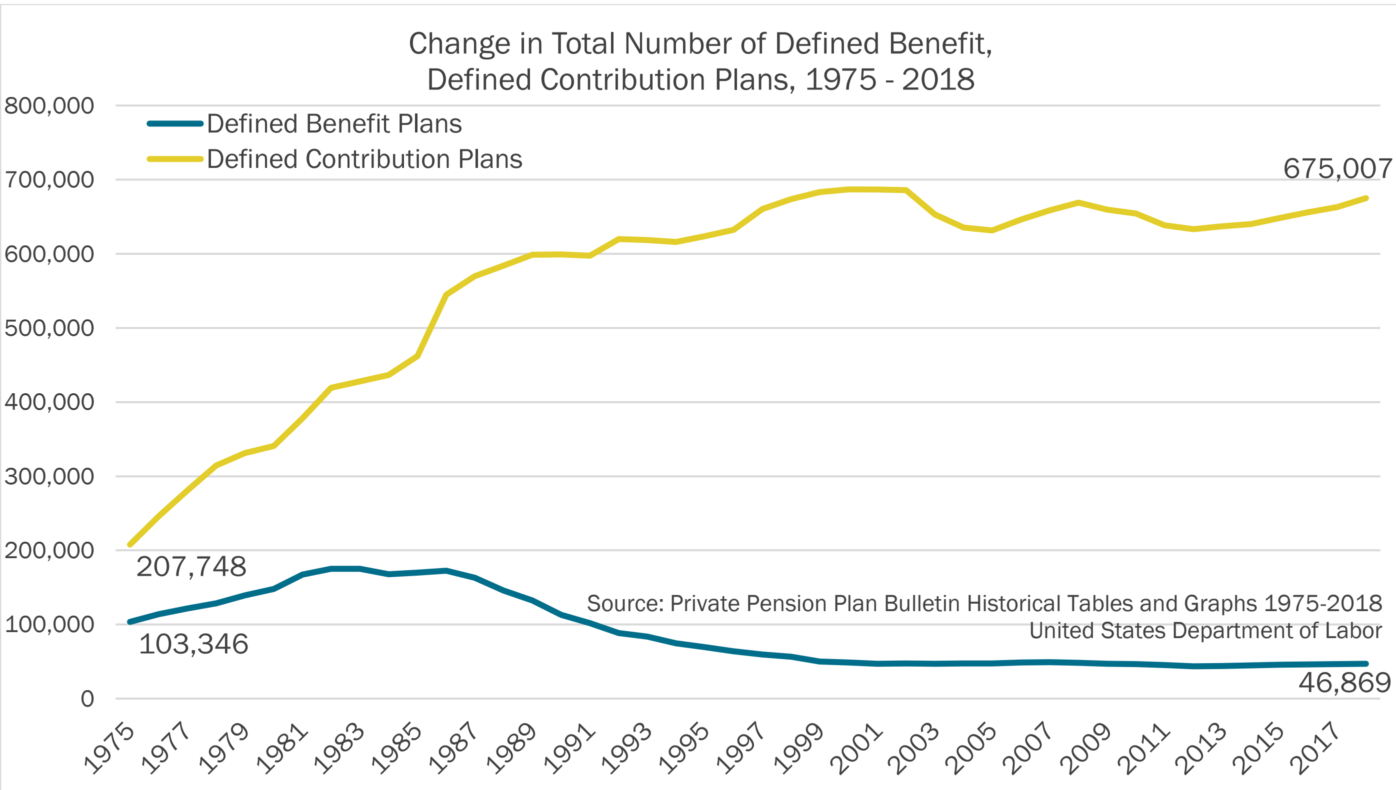
In this paper, we will briefly review changes in the retirement plan landscape from the enactment of the Employee Retirement Income Security Act of 1974 (ERISA) through today. We will address how these various changes have impacted—and in some cases, triggered—ERISA litigation, including topics such as:

- The relationship between plan design and litigation;
- Regulatory developments driving ERISA litigation;
- Market crashes and related liability;
- Wal-Mart and the demise of retail shares;
- The Schlichter Blitzkrieg;
- Impact of settlements; and
- The copycat effect.

Finally, we will conclude by presenting recommendations about how plan sponsors can mitigate their litigation risk.

DEVELOPMENTS IN THE RETIREMENT MARKET SINCE 1974

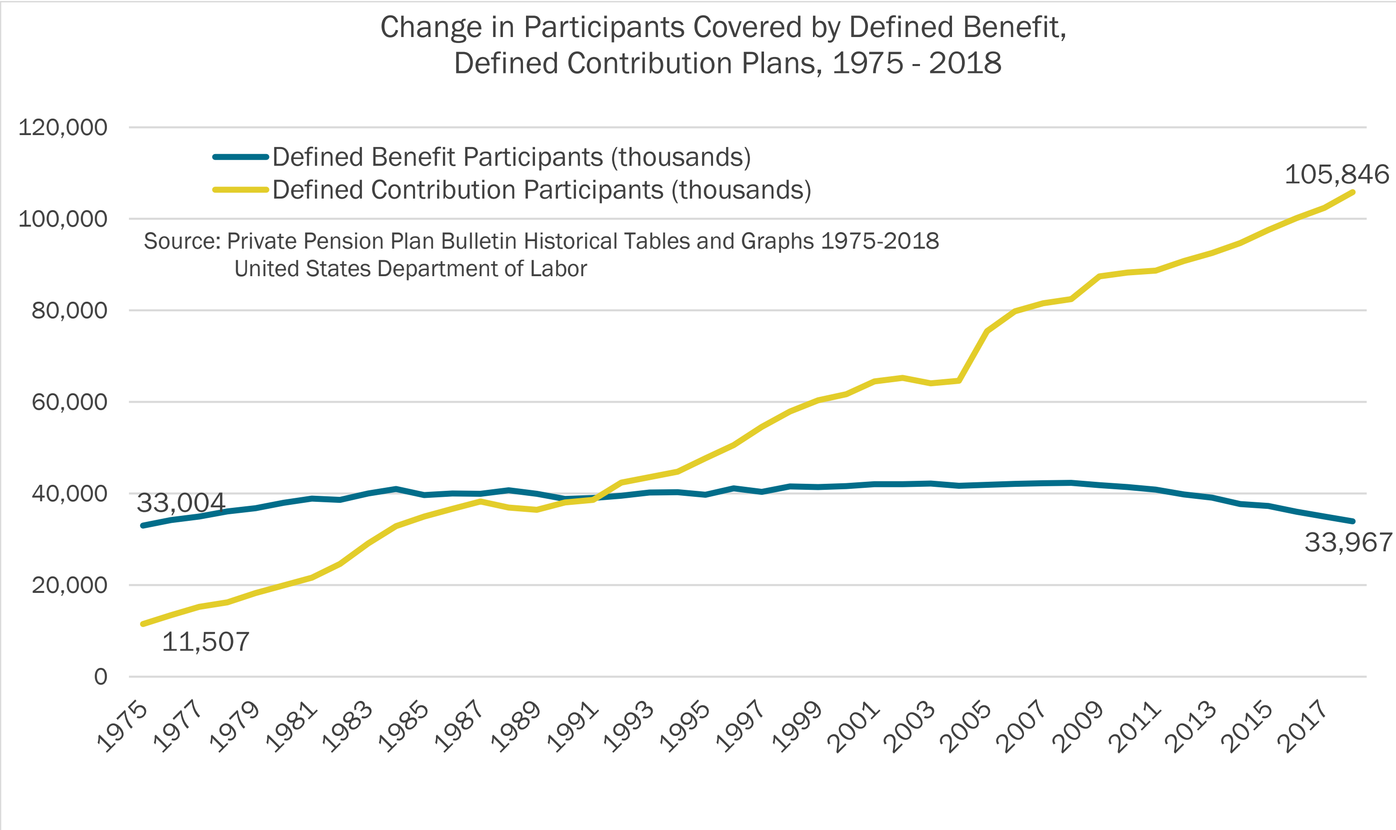
The demise of the traditional company-paid pension plan is a regularly reported trend in the popular press. For example, a December 2019 USA Today article titled "'It's really over': Corporate pensions head for extinction as nature of retirement plans change" reports "The practice of companies sending monthly retirement checks to their former workers is headed for extinction, and remaining pension funds are in tough financial shape … The number of pension plans offering defined benefits – which means the payouts are guaranteed – plummeted by about 73% from 1986 to 2016, according to the Department of Labor's Employee Benefits Security Administration." These statistics are accurate, but potentially misleading, as the following charts illustrate[i]. First, the total number of defined benefit pension plans in the US did drop from a peak of 172,642 in 1986 to 46,859 in 2001, with numbers virtually unchanged since then. During that same 1986-2001 time period, the number of defined contribution plans increased significantly.



Meanwhile, the number of people covered by defined benefit pension plans had a much less significant decline, from around 40 million participants in 1986 to around 34 million participants in 2018 (see the graph on the following page). That's because most of the terminated pension plans were very small, covering just a few workers, and because pension plans typically continue providing benefits across the lifespan of covered participants unless a lump sum cash out is offered and accepted — so the number of covered participants drops relatively slowly. Additionally, many defined benefit pension plans remained open for governmental and union workers. The reported 73% reduction in the number of pension plans translates to about a 15% reduction in the number of participants receiving pension benefits.

Balanced against the reduction in defined benefit pension plans, the number of defined contribution retirement plans more than tripled, from 207,748 plans in 1975 to 675,007 plans in 2018. Most of the growth in defined contribution plans came before 2000, and the number has remained virtually unchanged over the past twenty years.

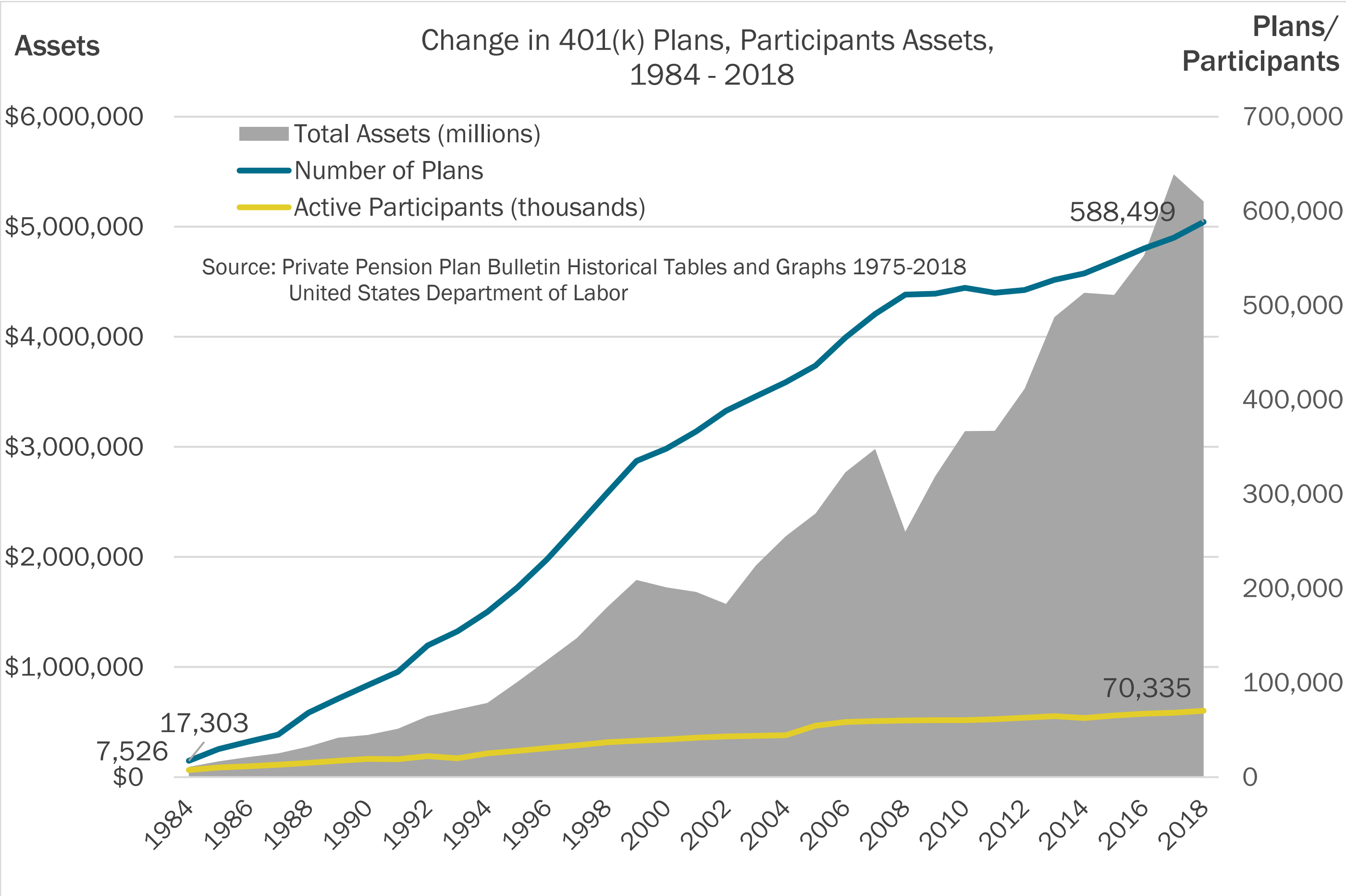
The pattern of participant coverage is even more pronounced. In 1975, roughly three times as many people were covered by defined benefit plans (33 million) as by defined contribution plans (11.5 million). But by 2018, the number covered by defined benefit plans was virtually unchanged, while defined contribution coverage skyrocketed to almost 106 million, three times the defined benefit number.



Infamous American bank robber William Francis Sutton, Jr. was asked why he robbed banks. His response, “Because that's where the money is,” represents the first part of our answer about why fiduciary litigation against defined contribution plans has accelerated in recent years. More participants and more money reside in defined contribution plans, making the plans more attractive targets for the plaintiffs’ bar.

And beyond the enormous growth in plans, participants and assets in defined contribution plans, there is a fundamental difference between defined benefit and defined contribution plans that makes defined contribution an attractive target for fiduciary litigation. Although both plans are governed by the same fiduciary standards under ERISA, defined benefit plans must pay a fixed amount defined under the plan terms. How the plan is administered, invested, or pays expenses typically has no impact on the benefit that must be paid out. With few exceptions, if the plan pays the promised benefit, would-be plaintiffs find little sympathy in the courtroom when making claims that a different management approach would have permitted the defined benefit plan to pay an even bigger benefit. Conversely, defined contribution plans track benefits in individual accounts, and the value of each account depends on factors under the fiduciary’s control, such as the performance of investment options, fees paid to service providers, and even how the plan is administered. So, there are many more factors that can potentially be challenged by a disgruntled defined contribution plan participant — or his or her attorney — that could trigger a lawsuit alleging breach of fiduciary responsibility.

The next key development in retirement plans — the 401(k) — could not have been anticipated when ERISA was established in 1974. That’s because Section 401(k) was added to the Internal Revenue Code by the Revenue Act of 1978, and implemented more fully with IRS regulations published in 1981. The Department of Labor (DOL) first began tracking 401(k) plans as a separate category in 1984. Much of the growth in defined contribution plans, participants and assets took place in the 401(k) space. By 1983, the Employee Benefit Research Institute (EBRI) reported that nearly half of all large firms already offered, or had considered offering, a 401(k) plan.



In 1975, prior to the advent of 401(k), 72% of retirement assets were held in defined benefit plans. But between 1984 and 2018, 401(k) plans became the dominant form of retirement benefit in corporate America. The number of 401(k) participants increased from 7.5 million to over 70 million, the number of plans from just over 17,000 to nearly 600,000, and the aggregate assets from less than $92 billion to more than $5 trillion. In total, by the end of 2018, retirement plans held $9.2 trillion in assets, with two-thirds of the total in defined contribution plans ($6.3 trillion), and more than half ($5.2 trillion) in 401(k) plans. Quoting Willie Sutton, plaintiffs' lawyers began targeting 401(k) plans with fiduciary lawsuits, "Because that's where the money is."

PERFORMANCE, PARTICIPANT DIRECTION AND POPULARITY

Now that we have demonstrated that 401(k) plans exploded in popularity between 1980 and the early 2000s, let's take a look at why the plans were so popular — and how the combination of asset growth and popularity growth triggered the current wave of fiduciary litigation.

The very earliest 401(k) plans were invested similarly to pension assets — funds were offered through institutional investment managers, there were a limited number of choices, assets were only valued quarterly (or even annually), and participants received account updates solely through paper statements sent through the mail. The plans' service providers were typically the actuarial and benefits consulting firms that supported traditional pension plans.

During most of the 1980s and 1990s, U.S. stocks performed unusually well as the economy recovered from 1970s stagflation. Mutual funds benefited from this strong market performance, giving the average American an opportunity to participate in the market boom. Leading mutual fund companies such as Fidelity, T. Rowe Price and Vanguard saw 401(k) plans as a way to market their management capabilities to large groups of potential customers. Services developed to support mutual fund sales and servicing, such as daily valuation, call centers and enhanced communications capabilities were adapted to support 401(k) plans. Mutual fund companies rapidly gained market share, typically at the expense of actuaries and benefits consultants. Organizations operating under a fee-for-service model found it impossible to compete with the fund companies, whose service costs were heavily subsidized by generous margins on fund management.

Some mid-sized mutual fund companies, such as Scudder and Franklin-Templeton, established 401(k) administration capabilities in attempt to participate in the booming marketplace. But without the benefits of scale enjoyed by the largest managers, these attempts to penetrate the 401(k) market were generally unsuccessful.

Other mutual fund companies, such as PIMCO and Janus, recognized that sharing a portion of their fund's management fees with leading 401(k) providers was a more cost-effective and successful way to have their funds offered to the 401(k) marketplace than developing and offering their own administration capabilities. Also, the leading 401(k) administrators recognized that offering programs that featured both their own and partner funds represented an effective marketing approach that was financially advantageous since payments from partner fund companies frequently represented larger revenue opportunities than margins available from the administrator's own fund options. The practice of "revenue sharing" was born, and rapidly became the dominant way to cover 401(k) administrative costs. Eventually, even fund companies offering 401(k) administration services, such as Fidelity and T. Rowe Price, also paid revenue sharing to have their funds featured on competitors' 401(k) administration platforms.

The 401(k) administration industry experienced massive consolidation in the early 2000s. Between 1999 and 2004, the list of major financial services firms (particularly banks) exiting the 401(k) administration business through outsourcing arrangements or outright sales included Chase Manhattan, CitiBank, Bank of America, Morgan Stanley, Wachovia, Bank of New York, SunTrust, American Century, Federated, Pioneer, Putnam, Scudder and Strong. As the 401(k) administration business consolidated, investment managers increasingly relied on revenue sharing for fund distribution, while administrators increasingly relied on revenue sharing to supplement their earnings. By the early 2000s, many 401(k) providers were marketing their administration services as "free," with all required income streams coming from revenue sharing payments.

As explicit 401(k) administration costs began to reach zero, the first cracks in the revenue sharing fee model began to appear. First, the stock market crash that began in March 2000 following the dot com boom of the 1990s interrupted the steady rise in average account balances that characterized the first twenty years of 401(k)s. Falling account values led participants and sponsors to take a closer look at factors such as fund expense ratios. Second, some industry practitioners began to question the prudence of using revenue sharing to cover all plan administration costs. While it was clear that 401(k) plans were governed by ERISA and therefore 401(k) plan participants were "… guaranteed the highest standard of conduct in the management and investment of assets for retirement that the law can establish," and that this trust law standard was "the highest known to law" [Donovan v. Bierwirth, 680 F.2d 263, 272 (2d Cir. 1982), there was no practical guidance for how fiduciaries were supposed to comply with these standards. Regulations implementing ERISA's fiduciary definitions and standards were published in 1975, prior to the development of 401(k) plans, and hadn't been updated. The 1982 Donovan v. Bierwirth decision also came prior to the mainstream adoption of 401(k) plans. Without clear regulatory guidance or established case law demonstrating exactly how fiduciaries were supposed to manage 401(k) plan fees, many fiduciaries simply ignored this duty.

2006 SCHLICTER BLITZKRIEG AND GAO REPORT, MILLER'S 2007 LEGISLATION AND DOL REGULATIONS

Aristotle is famous for many things, including the quote that "Nature abhors a vacuum." Prior to the fall of 2006, fiduciary standards for 401(k) fee management operated in an effective regulatory vacuum. Developments in 2006 and 2007 proved Aristotle right, at least for this quote.

On September 11, 2006, Saint Louis law firm Schlichter Bogard & Denton filed the first of an initial batch of eighteen class action lawsuits, later referred to as the "Schlichter Blitzkrieg." Defendants included many of America's largest companies, such as Boeing, Caterpillar, Deere, and Bechtel. Although the Schlichter lawsuits took numerous forms, general themes were that plan fiduciaries had failed to satisfy their ERISA responsibilities by allowing recordkeepers to charge excessive fees and by offering imprudent investment options. Schlichter directly targeted revenue sharing practices. This first wave of lawsuits touched off a decade of protracted and expensive litigation, including cases that went all the way to the Supreme Court. The final first-wave case, Abbott v. Lockheed Martin, settled in February 2016 for a reported $62 million, including a reported $22+ million in fees and costs to Schlichter. In the aggregate, settlements from the first wave of Schlichter lawsuits totaled more than $1 billion and generated more than $200 million in legal fees for the firm.

Also that fall, on November 16, 2006, the US Government Accountability Office (GAO) issued a report entitled "Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees"[ii]. Congressman George Miller, then the ranking minority member of the House of Representative's Committee on Education and the Workforce had asked the GAO to examine: "… the types of fees associated with 401(k) plans and who pays these fees, how information on fees is disclosed to plan participants, and how the Department of Labor (Labor) oversees plan fees and certain types of business arrangements." Like Schlichter, Congressman Miller had identified a vacuum in how 401(k) fees were required to be disclosed and reported and sought to introduce legislation to fill this vacuum. The GAO report was intended to help demonstrate the need for this legislation.

The GAO report included the following key findings:

- *"A 2005 industry survey estimated that investment fees made up about 80 to 99 percent of plan fees, depending on the number of participants in the plan. … Investment fees, which are usually charged as a fixed percentage of assets and deducted from investment returns, are typically borne by participants. … Plan record-keeping fees are … increasingly being paid by participants."* This finding demonstrates that the "free" 401(k) administration services marketed by some industry providers really just represented costs shifted from the sponsor to participants.
- *"The information on fees that … (ERISA) requires 401(k) plan sponsors to disclose is limited and does not provide an easy comparison of investment options … participants may not receive a clear picture of the total fees that they pay … the documents that participants receive do not provide a simple way for participants to compare fees — along with risk and historical performance — among the investment options in their 401(k) plan."* This finding demonstrates that participants are often unaware of the 401(k) costs being passed to them and lack a simple way to compare and potentially reduce the fees that they pay.
- *"Labor has authority under ERISA to oversee 401(k) plan fees and certain types of business arrangements involving service providers, but lacks the information it needs to provide effective oversight. … plan sponsors are not required to report mutual fund investment fees to Labor on the Form 5500 even though they receive this information from the mutual fund companies in the form of a prospectus. Without information on all fees, Labor's oversight is limited because it is unable to identify fees that may be questionable. … Labor and plan sponsors may not have information on arrangements among service providers that, according to officials at Labor, could steer plan sponsors toward offering investment options that benefit service providers but may not be in the best interest of participants. For example, a service provider that assists a plan sponsor in selecting investment options for the plan may also be receiving compensation from mutual fund companies for recommending their funds."* This finding demonstrates that revenue sharing practices developed between fund companies and 401(k) administration providers weren't subject to existing disclosure rules, making it difficult for Labor to enforce ERISA's general requirement that fees must be "reasonable," and potentially resulting in undisclosed conflicts of interest between service providers and plan sponsors and participants.
- *"Congress should consider amending ERISA to explicitly require 401(k) service providers to disclose to plan sponsors the compensation they receive from other service providers. … the Secretary of Labor [should] require plan sponsors to report a summary of all fees that are paid out of plan assets or by participants."* This finding demonstrates that the GAO identified both legislative and regulatory gaps in ERISA's 401(k) fee disclosure regimen—closing the gap would require both a law change mandating more complete fee disclosure from service providers to plan sponsors and a regulatory change mandating that plan sponsors compile the fee information they receive from providers into comprehensive, useful fee summaries.

The GAO report provided Congressman Miller with the ammunition he needed to propose legislation that would update ERISA to provide for more comprehensive 401(k) fee disclosures. At Congressman Miller's request, the House Committee on Education and the Workforce held hearings on 401(k) fees in 2007 (this author testified before the House Committee on Congressman Miller's proposed legislation on October 4, 2007). After control of the House shifted to the Democrats, Congressman Miller introduced the 401(k) Fair Disclosure for Retirement Security Act of 2009 (H.R. 1984) on April 21, 2009. But, for various reasons, including promised DOL regulatory initiatives and other legislative priorities relating to the Great Recession of 2008-09, H.R. 1984 was never enacted. Consequently, 401(k) fee disclosure standards remained stuck in a relative vacuum for several more years.

Nevertheless, the DOL did in fact follow through with a series of regulatory initiatives developed to address weaknesses in 401(k) fee disclosures, and responding to the GAO report, at least in part. The DOL initiatives included:

- Enhancements to fee reporting on the Annual Return/Report, Form 5500, which plan sponsors are required to file annually. Specifically, a new **Schedule C, Service Provider Information** was added to the Form 5500 for the 2009 filing year. But since 2009 filings weren't generally due until October 2010, and transitional rules simplified Schedule C reporting for the initial year, the new Schedule C didn't provide much public insight into 401(k) fees until 2012.
- Enhanced participant fee disclosure rules under ERISA Section 404(a)(5) were initially proposed in July 2008, and a final regulation was promulgated in February 2012. The first 404(a)(5) disclosures were subsequently published and sent to participants in 2014. This new regulation provided that 401(k) plans must deliver a table summarizing plan investment options and fees and performance for each investment option relative to a comparative benchmark. Notably, however, the participant fee disclosure regulations did not require that any information about revenue sharing arrangements be provided. While many practitioners lauded the objectives and consistent disclosure approach mandated by the new rules, there's little statistical or anecdotal information indicating that participants actually use these disclosures to make more informed plan investment decisions. Critics note that costs of distributing millions of printed fee disclosures are eventually passed back to participants themselves, meaning that an initiative intended to highlight 401(k) investment fees could, perversely, end up increasing fees. In response, in 2020, the DOL proposed updated electronic disclosure regulations permitting most participant fee disclosures to be provided online in electronic form.
- Enhanced plan sponsor fee disclosure rules under ERISA Section 408(b)(2) were proposed in December 2007 and finalized in February 2012. The 408(b)(2) regulation was the DOL's first attempt to define "reasonable compensation" in the context of a 401(k) plan. While the regulation did not prohibit revenue sharing arrangements, it required that all such arrangements be disclosed to plan sponsors in advance and made it clear that sponsors had a duty to ensure that such arrangements were reasonable, and that only proper fees were paid with revenue sharing funds. The 408(b)(2) regulation represented an exception to ERISA's general requirements concerning prohibited transactions. While a 401(k) provider would generally be prohibited from receiving revenue sharing compensation from a fund company, if the required 408(b)(2) disclosures were provided in a timely and appropriate manner, revenue sharing payments would not be treated as a prohibited transaction.

Although the DOL regulatory initiatives did eventually provide reasonable expectations for how 401(k) fees should be disclosed, the lack of clear regulatory guidance between the Schlichter lawsuits filed in September 2006 and implementation of the regulatory initiatives (generally between 2012 and 2014) created a volatile environment for litigation. Generally, the plaintiffs argued that sponsors failure to comply with DOL's regulatory guidance was evidence of a breach of fiduciary prudence standards, while defendants argued that the absence of definitive regulatory guidance should be construed to indicate that whatever actions the sponsor had taken should be acceptable, since no rules were violated. The ambiguity regarding applicable regulatory standards tended to drive contentious, costly legal arguments, potentially playing a role in defendants' decisions to settle many of these cases. Had regulatory guidance been issued earlier, the lawsuits still might have been filed, but far less legal wrangling would likely have ensued.

BRADEN v. WAL-MART AND RETAIL v. INSTITUTIONAL

The most significant excessive fee lawsuit brought after the initial Schlichter Blitzkrieg was Braden v. Wal-Mart Stores, Inc., filed on March 27, 2008. Although there were many similarities between Wal-Mart and the Schlichter cases, the lead attorney for Braden was the Seattle-based firm Keller Rohrback LLP. Braden's lawsuit against one of the country's largest retirement plans (which at the time held $10 billion in assets and covered more than one million participants) alleged numerous fiduciary breaches pertaining to Wal-Mart's failure to negotiate more favorable pricing on behalf of the plan. Braden claimed that by investing exclusively in retail mutual funds, the plan had incurred $60 million of excessive fees over the prior six years, and would continue to overpay by approximately $20 million per year until the issue was resolved. Braden further alleged that fund underperformance relative to index funds implicitly cost the plan an additional $140 million by the end of 2007. Finally, Braden alleged that there were conflicts of interest with the trustee, Merrill Lynch, including trust agreement terms that required the amount of revenue sharing to be kept secret, and that revenue sharing payments made to Merrill Lynch were "prohibited transactions."

Early rulings were favorable for the defendants—the district court dismissed the case in October 2008. But the Eighth Circuit Court of Appeals vacated the district court's judgment and remanded the Wal-Mart case to the lower court for further proceedings in November 2009. This was the first major appellate court ruling in favor of plaintiffs in fee litigation cases. The fact that a company as large and resourceful as Wal-Mart could lose at the Circuit Court of Appeals changed the dynamic for all fee litigation cases, putting much greater pressure on defendants to settle rather than face ongoing legal costs. Braden v. Wal-Mart Stores eventually settled for $13.5 million in December 2011, representing the fifth class settlement in a 401(k) fee lawsuit. The settlement amount was similar to the four other settlements, which ranged from $13.7- $18.5 million, but the precedent established was arguably far more important. Plaintiffs' firms other than Schlichter could be successful with excessive fee lawsuits, and appeals courts could reverse circuit court findings in favor of the defense. Braden v. Wal-Mart significantly increased the cost and risk of defending against an excessive fee lawsuit, placing greater settlement pressures on plan sponsors and their defense counsel.

MORE PLAINTIFFS FIRMS BRING SIMILAR CLAIMS

As the Schlichter Blitzkrieg lawsuits progressed through the legal system, results were mixed for plan sponsor defendants. Hecker v Deere (D. Wis.) represented a quick and comprehensive victory for the defense in June 2007, with the district court's decision being upheld by the Seventh Circuit Court of Appeals in February 2009. In brief, Hecker held that as long as some of a plan's investment options were prudent, a Section 404(c) defense protected fiduciaries against allegations that other plan investment options were imprudent. Hecker also held that fiduciaries had no participant disclosure obligations beyond complying with DOL regulatory requirements, which, as noted above, had not yet been implemented.

While not a complete victory for the defense, Kanawi v. Bechtel (N.D. Cal.) saw most claims dismissed early in the process. The litigation continued for several years, with Bechtel eventually agreeing to settle for $18.5 million in October 2010. Other, larger settlements negotiated in the Schlichter cases include:

- Spano v. Boeing, settled for $57 million in November 2015. Allegations included excessive fees and offering of an "excessively volatile" sector fund.
- Kruger v. Novant Health, settled for $32 million in November 2015: Allegations included excessive fees and a breach of fiduciary duty for failure to have an independent adviser review fees.
- Abbott v. Lockheed Martin, settled for $62 million in February 2016. Allegations included excessive fees and an overly conservative stable value fund.

Following the conclusion of the first wave of Schlichter Blitzkrieg lawsuits and the implementation of the DOL fee regulations, the Schlichter firm — and the DOL — was credited with triggering significant cost reductions for American workers participating in 401(k) plans. For example, in his ruling in Nolte v. Cigna, Judge Baker stated that nationwide, "fee reductions attributed to Schlichter, Bogard & Denton's fee litigation and the DOL's disclosure regulations approach $2.8 billion in annual savings for American workers and retirees." Similarly, Reuters columnist Linda Stern reported, "The law firm Schlichter, Bogard & Denton has had a humongous impact over the entire 401(k) industry, which has benefited employees and retirees throughout the country by bringing sweeping changes to fiduciary practices."[iii] And the New York Times reported that Schlichter's cases have been "good news for all 401(k) holders."[iv]

Then, generally beginning in mid-2015, numerous other plaintiffs' law firms began filing "copycat" style lawsuits against 401(k) plan fiduciaries and recordkeepers, generally following Schlichter's "proof of concept" excessive fee claims, but also introducing a broad range of varied and nuanced theories. General categories of claims include:

- Plan offered retail class fund options when it could have offered institutional share classes
- Plan offered a money market as its principal preservation option, when a stable value fund would have achieved higher earnings
- Plan offered a stable value fund employing an aggressive investment strategy, when a money market fund would have been less risky
- Recordkeeping fees were determined as a percentage of plan assets, when fixed per-participant fees would have been lower and more predictable
- Inadequate disclosures with respect to risk-based and target-date funds

- Failure of the plan sponsor to capture excess revenue sharing on behalf of participants, allowing the recordkeeper to generate excess profits
- Failure to routinely conduct an RFP for recordkeeping services
- Utilizing investment options with limited history (particularly when the investment option is managed by a plan service provider)

SAFETY IN NUMBERS AND THE HERD MENTALITY: UNIVERSITY LAWSUITS

In 2016, Schlichter began targeting a different category of plan sponsor, and, in most cases, a different type of plan. Approximately twenty excessive fee lawsuits were filed against retirement plans of renowned universities, such as MIT, Duke, Yale, NYU, Cornell, Northwestern, Columbia, University of Chicago, and Johns Hopkins. Although most higher education lawsuits were filed by Schlichter, a few universities were sued by other plaintiffs' firms. A particularly unlucky couple were sued by both Schlichter and another plaintiffs' firm. Due to the not-for-profit status of most university defendants, the plans sued were a mix of 401(k), 403(b) and 401(a) plans. Although the allegations were generally similar to claims brought against 401(k) sponsors in the corporate litigation, there were some differences in university litigation relating to the types of plan design typically offered in the higher education market. These differences include:

- Parallel lawsuits were filed concurrently against both 401(k) and 403(b) plans of the same plan sponsor
- Allegations of unnecessary and duplicative costs from having multiple recordkeepers support the same plan structure (a common practice in higher education retirement plans, where historically, providing plan participants with as much choice as possible over investment and operational platforms has been a typical university objective)
- Allegations that plans offered too many fund options, confusing participants with duplicative options and preventing the plan from benefiting from economies of investment scale that would have been possible if fewer options were offered (for reasons similar to offering multiple recordkeepers, as noted above).

Given how long it takes for cases to progress through the legal system, the university lawsuits are still relatively recent. Several cases are still active and are awaiting initial hearings or rulings. A few cases have already been resolved, with claims dismissed in favor of the defense (e.g., Georgetown and NYU). And several other cases have already settled, as universities seek to minimize legal fees and reputational damage inherent in being party to an active fiduciary breach lawsuit. Settlements include:

- University of Chicago – $6.5 million
- Vanderbilt – $14.5 million
- Duke – $10.65 million
- Brown – $3.5 million
- Princeton – $5.8 million
- Cornell – $225,000 (in the Cornell case, all but one of the plaintiffs' claims were dismissed on summary judgement. Per the settlement agreement, "the defendants are settling the released claim solely to avoid litigation costs and the risks associated with an in-person trial set for September 2020 amidst the current public health crisis.")

Reading through the plaintiffs' complaints in the higher education lawsuits, illustrates the risk in making decisions based on what other similarly situated institutions offer. It's apparent from the lawsuits that offering programs from multiple record keeping providers and offering hundreds of investment options is common in higher education. Offerings with four to six recordkeepers and two hundred or more total investment options were cited regularly in the lawsuits. It's also reasonably apparent that coordinating with multiple providers is duplicative and inefficient, with plan participants typically bearing these allegedly excessive costs. The number of settlements seems to validate that universities saw significant risk in defending their retirement plan practices in court. And that begs the question, why would universities adopt inefficient practices in the first place? The answer may lie in the herd mentality fallacy — if other similarly situated institutions take this approach, then it must be ok. The proposition is a "safety in numbers" defense — if most universities offer retirement programs through multiple providers, they can't all be wrong. Unfortunately, this "herding" approach to retirement plan management represents more of an opportunity to Schlichter and other plaintiffs' firms than a defense. Once Schlichter was able to negotiate a settlement from one university — perhaps targeting a figure just beneath the university's insurance coverage, or roughly equal to projected legal defense costs — Schlichter was better positioned to negotiate settlements with other similarly situated universities by leveraging the precedent set with the first settlement. By adopting similar, arguably inefficient plan designs, the universities collectively made themselves a larger target for the plaintiffs' firms.

CURRENT ERISA EXCESSIVE FEE LITIGATION

Although much economic activity slowed or ceased during the pandemic of 2020, ERISA excessive fee litigation accelerated at an unprecedented rate, with more than 90 lawsuits being filed during the year. With the market for higher education lawsuits apparently saturated, Schlichter returned to suing corporate 401(k) plans. Other plaintiffs' firms with less history in the ERISA space joined in, notably Capozzi Adler and Shepherd, Finkelman. Unlike the initial wave of Schlichter lawsuits, where a lengthy investigative process preceded a highly nuanced, custom crafted complaint targeted to the specific characteristics of a very large retirement plan, the newer lawsuits seem to present "cookie cutter" complaints, triggered by a database search to identify several potential defendant plan sponsors offering a common set of plan investments or design options. Complaints are then a matter of "copy and paste," with a replacement function being used to update references to the defendant. Indeed, as defense firm Morgan Lewis & Bockius' noted in their motion to dismiss the excessive fee case filed against the University of Miami, "Complaint is a literal copy-and-paste job: Its allegations, right down to the typos, are lifted directly from complaints in other cases…"

As the cost to investigate potential claims and develop a complaint good enough to survive a defense motion to dismiss has fallen, the plaintiffs' bar has begun targeting sponsors of smaller plans. Previously, litigation almost exclusively targeted plans with over $1 billion in assets; in 2020, lawsuits were filed against plans with as little as $4.5 million in assets. And as the cost of defending against this litigation has risen, pressures to settle have also increased. Only about one in three motions to dismiss have been successful in eliminating all plaintiffs' claims. Since 2015, sixty percent of excessive fee cases open for two years or more have settled, with total settlements reaching over $1.2 billion. The plaintiffs' attorneys share of settlements since 2015 has been $285 million, with over $200 million going to Schlichter.

It is this relentless push towards settlements that could make ERISA fiduciary risk uninsurable. Very few cases are actually decided for the plaintiffs. But as fiduciary liability insurance provider Euclid Specialty notes: "Plaintiff firms only have to claim negligence; assert a purported benchmark; and then hope to survive a motion to dismiss to leverage the crushing cost of litigation and huge damage models, coupled with the fear of individual liability under ERISA fiduciary law. … plan sponsors being sued face immense pressure to settle any claims that survive the pleadings stage, because ERISA class actions are extremely costly to litigate." Euclid reports that the fiduciary insurance marketplace is pushing claims risks back to plan sponsors due to the large number of settlements in ERISA fee cases: "While most plans focus on premium increase, the key change in the fiduciary market is the increased level of policyholder retentions. Many large plans now face retentions [deductibles] of one to five million dollars. Plan sponsors can no longer rely exclusively on fiduciary insurance to fund and absorb these losses."[v]

In one currently pending excessive fee case, defense firm Morgan Lewis has argued for a stay of discovery pending the court's ruling on a defense motion to dismiss the case. Morgan Lewis argues that the cost to review and produce documents requested by plaintiffs' counsel would exceed $1 million, and the cost to conduct depositions would be approximately $4 million. If these projected costs are accurate, and the court does not approve the stay, legal defense costs could exceed $5 million in this case before the court can rule on the defense motion to dismiss. Given the current high legal defense costs, it's understandable why many plan sponsors choose to settle rather than continuing to incur legal fees. And with the plaintiffs' bar typically receiving 25% or more of settlement proceeds, it is easy to see why the plaintiffs' bar is willing to drive up defense costs to make settlements relatively more attractive.

Recent ERISA litigation continues many of the themes from the initial Schlichter Blitzkrieg of September 2006. Some of today's newer or more specific allegations include:

- Fiduciaries failed to consider investment vehicles other than mutual funds when selecting plan options. Collective investment trusts (CITs) and separate accounts are cited as alternatives that should be considered.
- Fiduciaries were imprudent in their selection and monitoring of target date funds (TDFs), particularly when the TDFs:
    - » Serve as the plan's qualified default investment alternative (QDIA)
    - » Are managed by an affiliate of the plan's recordkeeper

    - » Are new and lack history for evaluation
    - » Are actively managed, and a less expensive indexed set of TDFs is also offered (although indexed TDFs can also trigger litigation, e.g. in Brown-Davis v. Walgreen, plaintiffs objected to the selection of indexed TDFs managed by Northern Trust, and calculated potential damages by comparing the returns of the indexed Northern Trust TDFs relative to the returns of actively managed TDFs from Fidelity and T. Rowe Price. Ironically, the Fidelity and T. Rowe Price TDFs have also been the subject of litigation, with potential damages for these funds determined through comparison with the performance of indexed TDFs. The plaintiffs' bar is known for creativity in damage calculations.)
- Fiduciaries imprudently permitted the use of funds managed by an affiliate of the plan's recordkeeper and/or deferred to recordkeeper fund recommendations, thereby triggering additional revenue for the recordkeeper

TECHNIQUES FOR MANAGING ERISA LITIGATION RISK

ERISA litigation risk is clearly significant for fiduciaries. For 401(k) plans, excessive fee litigation is typically the most common type of ERISA litigation risk, particularly if company stock is not offered as a plan investment option. Thankfully, there are many strategies that plan sponsors can employ to mitigate ERISA litigation risk.

- Risk mitigation strategies based on <u>governance procedures</u>:
    - » Appoint a committee to oversee the plan's fiduciary responsibilities
    - » Define the duties of the committee in writing (via a committee charter) and have the committee review the duties and charter periodically
    - » Have the committee develop, adopt and periodically review an investment policy statement (IPS), possibly with the assistance of an independent investment adviser
    - » Hold periodic meetings (e.g., quarterly), distribute agendas and materials in advance, and prepare minutes that memorialize actions and decisions taken at meetings
    - » Consider involving qualified legal counsel in committee meetings/plan review process
    - » Ensure fiduciaries are properly appointed and appropriately trained
    - » Review fiduciary liability insurance coverage, ensure limits and deductibles are appropriate
    - » Review communications from plan vendor to participants
    - » Periodically (e.g., annually) report on committee activities to appointing body (typically a board of directors or compensation committee)
- Risk mitigation strategies based on <u>fee management</u>:
    - » Periodically conduct an RFP to benchmark recordkeeping fees (every 5–10 years)
    - » Run independent fee benchmarking studies between RFPs (at least every 2-3 years)
    - » Consider migrating from asset-based recordkeeping fees to flat per-participant fees
    - » Have at least a portion of plan's fees paid from corporate sources (not plan assets)
    - » Monitor service providers and fees paid from plan assets; ensure that only permissible fees are paid from plan sources; and that such fees are reasonable
- Risk mitigation strategies based on <u>investment management</u>:
    - » Hire appropriate investment advisers and consultants to enable the committee to carry out its duty to select and monitor available investment funds (independent investment review)
    - » Ensure the plan offers a broad range of actively managed and indexed funds
    - » Review share classes used, and document the rationale behind any decision to select or retain a higher cost share class
    - » Select funds that minimize or eliminate revenue sharing payments
    - » Consider use of Collective Investment Trusts (CIT's)/separate accounts and document the rationale for all investment vehicle decisions, particularly if lower cost CITs are not selected
    - » Consider migrating from fully active target date suites to indexed or blended suites, and document the rationale for the decision if a fully active target date suite is selected/retained

Effective risk management requires more than just selecting good funds for a plan. It should be a comprehensive process, incorporating effective plan governance, consideration of preferred fee structures and arrangements, reasonable investment design, and a well-balanced fund selection process.

CONCLUSIONS

There are a broad range of opinions about whether 401(k) excessive fee litigation has been a positive or negative development. While acknowledging that litigation has been a contributing factor to 401(k) fee reductions, those responsible for marketing fiduciary insurance, like Euclid Specialty, see the litigation as primarily negative: "Retirement plan fees have indeed gone down, but not without wasteful litigation time and expense." "These cases represent litigation profiteering in its most insidious form." "It does not take much cynicism to prove that excessive fee litigation is less about helping retirement plan participants than funding an opportunistic business model for America's plaintiff's bar." Others, like Linda Stern of Reuters, see interventions, such as litigation led by Schlichter and other firms, as a necessary force for improvement in retirement plans: "It's also a sign that employee-funded defined-contribution retirement plans still are imperfect, despite improvements and increasing attention from regulators and activists like Schlichter."

In our opinion, the truth probably lies somewhere between the two extremes, and is at least partly an artifact of how the 401(k) developed as America's primary retirement program. Over time, pension plans diminished in importance, while participant-directed defined contribution plans became the dominant form of retirement benefit program — under a regulatory framework developed primarily for pension plans. The DOL got stuck playing catchup, drafting new regulations and revising older rules to address how fees should be assessed and disclosed in a new type of plan that didn't exist twenty-five years earlier. Without any clear and consistent regulatory guidance, it's apparent that some plan sponsors did a poor job of managing plan fees, potentially rising to the level of negligence. But it's also clear that the plaintiffs' bar has used the threat of ongoing scorched-earth litigation tactics to pressure sponsors into making settlements in cases where prudent fiduciaries diligently sought to make reasonable options available to participants. Courts find it difficult to resolve these highly technical cases fairly and consistently, leading to conflicting decisions, which in turn trigger higher legal costs as plaintiffs' and defense attorneys cite similar cases with dramatically different rulings.

We advise fiduciaries to focus on developing and maintaining appropriate plan governance structures and prudent cost management techniques. The best way to manage 401(k) excessive fee litigation is to avoid being sued in the first place. And with a solid governance structure in place, and regular, well-documented fee analytics and reviews, fiduciaries who are unlucky enough to be sued should have a fighting chance of resolving the case early in the process, before escalating legal fees make settlement a necessary consideration.

---

[i] "Private Pension Plan Bulletin: Abstract of 2018 Form 5500 Annual Reports, Data Extracted on 6/30/2020", United States Department of Labor, January 2021"
[ii] "Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees: Report to the Ranking Minority Member, Committee on Education and the Workforce, House of Representatives", United States Government Accountability Office, November 2006
[iii] "Stern Advice—How 401(k) Lawsuits Are Bolstering Your Retirement Plan", REUTERS, Linda Stern, November 5, 2013
[iv] "A Lone Ranger of the 401(k)'s", THE NEW YORK TIMES, Gretchen Morgenson, March 29, 2014
[v] "Exposing Excessive Fee Litigation Against America's Defined Contribution Plans", op. cit.