LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com

WEDNESDAY, JULY 14, 2021

PERSPECTIVE

High court case will provide guidance to ERISA fiduciaries

By Elise Klein

The U.S. Supreme Court recently granted certiorari in *Hughes v. Nortwestern University,* 19-1401, in which plaintiff members of two ERISA pension plans claimed that the plans and trustees breached their fiduciary duty of prudence with respect to some of the investment options provided to plan participants. The court's decision should provide additional guidance to ERISA fiduciaries with respect how to administer a pension plan prudently.

The Employee Retirement Income Security Act requires fiduciaries of an employee benefit plan to discharge their duties "with the care, skill, prudence, and diligence" that a similarly situated fiduciary would use. 29 U.S.C. 1104(a)(1)(B).

Plaintiffs brought suit in the Northern District of Illinois alleging that the plan and its trustees violated ERISA because (1) the plan offered an excessive number of investment options; (2) some of the investment options charged fees substantially higher than alternative available investment products; (3) some of the investment options offered by the plan underperformed the market; and (4) recordkeeping fees for some of the investment options were too high. The district court dismissed the complaint and the first amended complaint for failure to state a claim. Plaintiffs sought leave to file a second amended complaint, which was denied. The district court ruled, in a 2018 unpublished opinion, that plaintiffs did not state a claim, because no plan participant was required to invest in the underperforming funds or those charging excessive fees; they could simply choose other options. The court rejected, as "paternalistic," plaintiffs' allegation that too many funds were offered to participants. The court rejected plaintiffs' theory that record keeping charges should be assessed per participant, rather than as part of the expense ratio, noting that a per capita charge could discourage and punish small investors. The district court also rejected plaintiffs' alternative theory that the charges constituted prohibited transactions.

The 7th U.S. Circuit Court of Appeals agreed. In *Divane v. Northwestern Univ.*, 953 F.3d 980 (7th Cir. 2020) (referenced as *Hughes* throughout this article), the 7th Circuit held that ERISA did not guarantee plan participants their preferred investment options. The 7th Circuit noted that plaintiffs acknowledged the "valid reasons" for two separate recordkeepers, which defeated the imprudent fiduciary claims. The 7th Circuit also noted that it was not imprudent to offer a large variety of funds, and the "ultimate outcome of an investment is not proof of imprudence." Finally, the 7th Circuit rejected plaintiffs' claim that the conduct at issue constituted prohibited transactions.

Plaintiffs then petitioned for a writ of certiorari, asserting that the 3rd, 8th and 9th Circuits have held that allegations of excessive fees and charges state a claim for breach of fiduciary duty while permitting a plan participant to plead a breach of fiduciary duty claim by alleging that a retirement plan should have offered lower-cost investments. Before granting the writ, the Supreme Court asked the solicitor general for comments. The solicitor general agreed with plaintiffs that plan fiduciaries should not select retail funds, which charge higher management and administrative fees, when institutional-class funds, with lower fees, were available to the plans based on their size. She also argued that the fiduciaries had an obligation to monitor and reduce the Plans' recordkeeping costs. While she did not take a position on the remaining claims, she argued that the court should clarify that ERISA requires fiduciaries to take steps to limit a plan's expenses and remove imprudent investments.

The solicitor general highlighted the importance of the issues presented in this case, noting that millions of employees have retirement assets invested in ERISA-governed plans. Further, there is a dispute between the circuit courts, suggesting that review is appropriate.

It seems unlikely that the Supreme Court will grant in full the relief sought by plaintiffs.

There is no agreement among the circuit courts as to what conduct breaches a trustee's fiduciary duty.

While plaintiffs in *Hughes* complain that they were offered too many choices, it seems unlikely that the Supreme Court will issue a ruling which strictly limits the number of investments a plan can offer.

In *Sweda v. Univ. of Pa.*, 923 F.3d 320, 329 (3rd Cir. 2019), plaintiffs were permitted to allege breach of fiduciary duty based on the fiduciaries' inclusion of underperforming, costly funds and funds with high charges. *Sweda*, like *Hughes*, rejected plaintiffs' contention that the inclusion of underperforming and expensive investments constituted a prohibited transaction under ERISA. In *Hughes*, the 7th Circuit held that plan participants could not state a claim for breach of fiduciary duty based on the inclusion of underperforming, costly funds, the inclusion of recordkeeping fees as part of the expense ratio and too many fund choices. In *Davis v. Wash. Univ. in St. Louis*, 960 F.3d 478 (8th Cir. 2020), decided after *Hughes*, the 8th Circuit agreed with *Sweda* that a breach of fiduciary duty claim could be alleged for failure to monitor the investment advisors' fees, but held, as did *Hughes*, that no such claim could be alleged because some funds were poor performers and cost too much, in light of plaintiffs' failure to identify benchmarks for comparison.

While plaintiffs in *Hughes* complain that they were offered too many choices, it seems unlikely that the Supreme Court will issue a ruling which strictly limits the number of investments a plan can offer. Similarly, it seems unlikely that the court will issue a ruling requiring trustees to eliminate poorly performing funds. As implicitly recognized by the district court and the 7th Circuit, changing market conditions can dramatically improve — or worsen — a fund's performance. Similarly, the index funds praised by the plaintiffs have the lowest cost ratios but are not actively managed, so may not meet investors' expectations. Finally, plan trustees are no more likely than other financial planners to be able to anticipate market conditions accurately. As a result, the Supreme Court is unlikely to issue a bright line rule dictating the investment vehicles which a plan may make available to employees. Instead, as in *Sweda*, the court may focus on the process followed by fiduciaries, and provide guidance as to the factors fiduciaries should consider — and carefully document — when offering investment options to plan participants. ■

Elise Klein *is a partner in the Los Angeles office of Lewis Brisbois Bisgaard & Smith LLP and chair of the Life Health Disability & ERISA Practice.*