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Oral Arguments in the *Hughes v. Northwestern* ERISA Excessive Fee Case

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If you had the choice to offer brand name sodium chloride or non-brand name sodium chloride, would it be imprudent to offer the brand name sodium chloride?¹ This is how the oral arguments went on December 6, 2021, and this article will delve into those arguments. Based on the arguments and questioning, it is unclear where the Supreme Court is leaning.

The *Hughes v. Northwestern* case is an ERISA² excessive fee case, which was dismissed in the district

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¹ Transcript of Oral Argument at 90:1-6, *Hughes v. Northwestern University* (U.S. Dec. 6, 2021) (No. 19-1401). Hereinafter referenced as Transcript of Oral Argument in the citations below where appropriate.

² ERISA refers to the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406.

court,³ and later this dismissal was affirmed by the Seventh Circuit.⁴ The U.S. Supreme Court granted certiorari in *Hughes v. Northwestern Univ.*, to determine whether, at the pleadings stage, allegations that a defined contribution plan paid or charged its participants fees that substantially exceeded fees for alternative available investment products or services are sufficient to state a claim against fiduciaries for breach of ERISA's duty of prudence.⁵

Interestingly, the oral arguments were void of any discussion on the type of plan at issue. These are participant-directed defined contribution plans. Participant-directed is exactly what it states, it is an account in which the participant exercises control over. ERISA §404(c) provides a safe harbor for fiduciaries "... no person who is otherwise a fiduciary shall be liable ... for any loss, or by reason of any breach, which results from such participant's exercise of control." The U.S. Department of Labor (DOL) regulations under this section provides, among other things, that the participants be "a offered broad range of investment alternatives, which consist of at least three diversified investment alternatives, each of which has materially different risk and return characteristics."⁶ Justice Thomas appeared to be going in that direction when he requested further comment on the large menu defense,⁷ but the argument was limited to

³ *Divane v. Northwestern Univ.*, No. 16 C 8157, 2018 BL 186065 (N.D. Ill. 2018).

⁴ *Divane v. Northwestern Univ.*, 953 F.3d 980 (7th Cir. 2020).

⁵ See Jose Jara, Richard Lynn, Sheldon S. Miles, *In ERISA Excessive Fee Cases, Will the Supreme Court Issue Guidance for Dividing the Plausible Sheep From the Meritless Goats?*, 49 Tax Mgmt. Comp. Plan. J. No. 11 (Nov. 5, 2021) (discussing the issues and briefings in greater detail).

⁶ 57 Fed. Reg. 46,906 (Oct. 13, 1992); See also Jose Jara and Fassano, "What You Don't Know, [Can] Hurt You' – ERISA's Statute of Limitations Conundrum", 47 Tax Mgmt. Comp. Plan. J. No. 11 (Nov. 1, 2019) (discussing the ERISA §404(c) regulations in greater detail).

⁷ Transcript of Oral Argument at 60:8-12.

the number of options and not that participants are in control of their accounts.⁸

PETITIONERS' ARGUMENT: WE RATHER PAY ONE DOLLAR INSTEAD OF TWO DOLLARS FOR THE SAME BOTTLE OF WATER

Petitioners' argument is built on three pillars: (i) the Seventh Circuit's decision runs counter to the Court's prior decision in *Tibble v. Edison*,⁹ and ERISA §404; (ii) respondent's decision to choose retail shares over institutional shares lead to excessive investment fees for the plan participants; and (iii) respondents failed to use its leverage to negotiate for lower administrative costs or engage in competitive bidding for recordkeeping services.

Petitioners begin by weaving through ERISA's prudence standard under ERISA §404, which requires fiduciaries to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims" and to deter unreasonable expenses.¹⁰ Petitioners note that if the Court adopts the Seventh Circuit's ruling and therefore allows for ERISA plans to be made up of an array of investment options (some of which are prudent and others are not), then there will be no check on fiduciaries. Petitioners also tie in Court's holding in *Tibble*¹¹ that imposes a duty on fiduciaries to monitor investment options and to remove imprudent ones. The gravamen of petitioners' argument is that ERISA is a process statute, which requires courts to examine the decision-making process of a fiduciary and compare it to the industry rather than focus on the outcome.

Building off that last point, petitioners pointed to respondents failure to promptly act to guidance issued by the DOL in 2007 as well as to plan design trends for 403(b) plans. More specifically, petitioners drew the attention of the justices to the changes respondents made in 2016 to consolidate recordkeepers, offering institutional class shares, and using its weight to ask for rebates from recordkeepers. Additionally, petitioners suggested that respondents were behind the curve

because similar institutions¹² made these changes years prior. Petitioners argued that respondents' decision to overhaul its retirement plan in 2016 is more than enough to suggest that respondents' past behavior was imprudent. However, Chief Justice John Roberts questioned whether it would incentivize plan fiduciaries to not fix things since then they would be in trouble for fixing them.¹³

Petitioners also maintained that respondents should have consolidated the plan's investment menu, which would have led to lower investment fees because the minimum investment requirements imposed on institutional class shares would have been waived. Petitioners go into great length in explaining that it is imprudent for retirement plans, with significant assets, to offer retail class shares that often impose higher investment fees than institutional class shares. Petitioners made the analogy to paying for a bottle of water worth two dollars instead of choosing the same type of water for only one dollar. Mixed in between analogies to spaces shuttles, gasoline, and produce, Justice Kagen raised the question – doesn't consolidation of funds hurt a plan's diversification?¹⁴ Although not stated in petitioners' petition, they acknowledged that the individual named plaintiffs were confused by all of the options in the plan.¹⁵

As for recordkeeping fees, Justice Sotomayor pointed out that a recordkeeping price of \$35 per participant is not supported by what was pled in the complaint.¹⁶ Petitioners argued that this is a proxy, and notes that four other universities lowered their recordkeeping and administrative expenses by consolidation. Furthermore, petitioners references that 90% of 403(b) plans have only one recordkeeper, all having lower recordkeeping and administrative fees than respondents.¹⁷ Notably, petitioners did not argue that it is imprudent per se to have more than one recordkeeper, but rather that by consolidating recordkeepers a plan can reduce its administrative costs. Thus, respondents could have two or more recordkeepers, but they needed to solicit bids and use their leverage to lower service providers' costs.

In support of the petitioners, the U.S. government outlined several reasons for why the Seventh Circuit's holding is wrong – (i) it has no support in the common law or trust; (ii) it is inconsistent with *Tibble and*

⁸ In their brief, the respondents do make the argument that in participant-directed accounts, the participants are in control. See Resp. Brief pp. 5-6, 20-21.

⁹ 575 U.S. 523 (2015).

¹⁰ ERISA §404.

¹¹ *Tibble v. Edison Int'l*, 575 U.S. 523 (2015). In *Tibble*, plan participants alleged that fiduciaries of a defined contribution plan were imprudent by failing to remove six retail class mutual funds for institution class funds that charge a lower expense ratio.

¹² Petitioners' reference: Cal Tech, Purdue, Pepperdine, and Loyola Marymount. Transcript of Oral Argument at 17: 13-18.

¹³ Transcript of Oral Argument at 46:1-6.

¹⁴ Transcript of Oral Argument at 18:2-8.

¹⁵ Transcript of Oral Argument at 36: 14-21.

¹⁶ Transcript of Oral Argument at 30:18-25, 31:1-6.

¹⁷ Transcript of Oral Argument at 32:7-14.

*Fifth Third Bancorp v. Dudenhoeffer*¹⁸ and (iii) it provides immunity to plan fiduciaries.¹⁹ The government explained that ERISA is derived from trust law, which requires trustees to engage in a cost comparison of plan alternatives. Additionally, they claim that by allowing fiduciaries to meet their statutory duties by offering an array of investments, the Court will contradict its holding in *Dudenhoeffer*, which refused to adopt a special rule favoring a fiduciaries prudence.

RESPONDENTS' ARGUMENT: THIS IS NOT THE CASE OF THE CONTAMINATED OYSTER

Respondents opened with an excoriating rebuke of petitioners' case as but "one of a barrage of damages actions filed against leading universities across the country" intended "to revolutionize fiduciary practices not through prospective changes to ERISA or its regulations but through the blunt threat of damages actions for past conduct."²⁰ Respondents then outlined three overarching reasons why the Court should affirm the Seventh Circuit's finding that the amended complaint at issue fails to state a claim under ERISA:

1. Petitioners' "flawed conception of the duty of prudence overlooks the role that Congress left for participant choice" and operates to "strip fiduciaries of the leeway they have always had to consider tradeoffs in addition to cost, such as the impact that minimum investment requirements for institutional class shares would have on providing investment options generally[;]"²¹
2. "[T]he complaint fails to allege facts from which there could be a reasonable inference that the alternative fees and services that [petitioners] claim should have been provided were actually available to the plans[;]"²² and
3. Allowing claims as stated by petitioners "to proceed not only would subject retirement plans to endless damages litigation but would thrust the federal courts into the role of micromanaging those plans."²³

On trend, Justice Thomas was the first to ask a question from the bench,²⁴ inquiring as to the perceived insignificance respondents placed on the

"large menu defense" discussed by the Seventh Circuit.²⁵ In response, respondents remarked that the very idea of an "administrable line of whether a plan is too diverse or not diverse enough is essentially a Goldilocks rule that the courts could never administer."²⁶

Justice Kagan entered the fray next, asking a series of questions directed at the seminal issue of whether a bevy of plan options operates to excuse a fiduciary's failure to obtain lower-prices for certain plan options.²⁷ Respondents retorted by pointing out the absurdity of allowing a plaintiff to "plead [it]self into federal court and a million dollars of costs of discovery just by saying you should have asked for a one-of-a-kind deal or a waiver from those requirements[.]"²⁸ This response prompted Justice Kagan to ask why a plaintiff could not state a claim by alleging "all your competitors are paying far lower fees than you are for the exact same service?"²⁹ In turn, respondents conceded that this would in fact get "closer to . . . stating a claim . . . because, in that instance, you would actually provide a benchmark" but that petitioners did not provide such a benchmark in this case.³⁰

Justice Breyer then picked up the mantle, engaging in a probing exchange with respondents to evaluate the level of specificity required for a complaint to sufficiently plead that other alternatives were available to fiduciary-defendants.³¹ Respondents focused the Court's attention on the fact that while the complaint at issue may have specified alternative fund options by name, it did not plead facts to allow the Court to infer that those funds were in fact available to respondents since, for example, petitioners did not plead facts concerning the minimum investment required for those institutional funds.³² Respondents went on to note that if a stand alone allegation that the fiduciary should have asked for a waiver from minimum thresholds, then this would drive a hole through *Ashcroft v. Iqbal*³³ and *Twombly* that would infect not just ERISA jurisprudence but civil jurisprudence generally.³⁴

This prompted Justice Kagan to ask whether respondents were defending the Seventh Circuit ruling "that fiduciaries can avoid liability for offering imprudent investments with unreasonably high fees if they

¹⁸ 573 U.S. 409 (2019).

¹⁹ Transcript of Oral Argument at 43:11-20.

²⁰ Transcript of Oral Argument at 58:12-18.

²¹ Transcript of Oral Argument at 58:23-59:7.

²² Transcript of Oral Argument at 59:8-20.

²³ Transcript of Oral Argument at 59:21-60:5.

²⁴ Kimberly S. Robinson, *Thomas Keeps Asking Questions as Justices Return to Courtroom*, Bloomberg Law (Oct. 5, 2021).

²⁵ Transcript of Oral Argument at 60:9-13.

²⁶ Transcript of Oral Argument at 60:14-21.

²⁷ Transcript of Oral Argument at 61:25-64:5.

²⁸ Transcript of Oral Argument at 64:6-12.

²⁹ Transcript of Oral Argument at 64:13-17.

³⁰ Transcript of Oral Argument at 64:18-22.

³¹ Transcript of Oral Argument at 66:7-10.

³² Transcript of Oral Argument at 73:8-15.

³³ 556 U.S. 662 (2009).

³⁴ Transcript of Oral Argument at 78:3-12.

also offer prudent investments with reasonable fees.”³⁵ Respondents, after objecting to the Justice’s characterization of that ruling,³⁶ offered the analogy that this is not a case of a contaminated oyster but rather a case where participants are presented with an oyster from the Chesapeake and one from Apalachicola, and one happens to be more expensive but the choice is left to the participants.³⁷ To that end, respondents acknowledged that while choice, by itself, is not a defense,³⁸ allowing petitioners claims to proceed would then allow any plaintiff to subject a plan to the threat of massive damages and millions of dollars of discovery just by alleging that a cheaper fee, asset, or service was available, even if they provide no facts that would support an inference that such fee or service was actually available to the plans.³⁹ Respondents closed by underscoring the fact that this would: (1) “drive a hole through the pleading standards that this Court has established in *Iqbal* and *Twombly*,” (2) “thrust the courts into a role that they are not well suited to in micromanaging plans;” and (3) “harm re-

³⁵ Transcript of Oral Argument at 85:3-11.

³⁶ Transcript of Oral Argument at 85:12-14.

³⁷ Transcript of Oral Argument at 86:14-25.

³⁸ Transcript of Oral Argument at 89:7-15.

³⁹ Transcript of Oral Argument at 92:1-9.

tires and employees as plans struggle with the heightened costs, administrative burdens of litigation as premium insurance skyrockets.”⁴⁰

CONCLUSION

Plan fiduciaries should take a proactive approach to mitigate risks by assessing: (1) investments options in their plans (in terms of performance and fees charged); and (2) service providers. The standard set forth by the DOL is a comparison of the quality of services with fees being charged. Note, that in certain cases, evidence of subsequent remedial measures are excluded.⁴¹

This case has large ramifications for plan sponsors of participant-directed defined contribution plans. The optimistic view is that the Supreme Court will issue guidance as to what needs to be pled in a complaint alleging ERISA breach of fiduciary duties for paying excessive fees in a defined-contribution plan.

⁴⁰ Transcript of Oral Argument at 92:10-18.

⁴¹ *Acosta v. Chimes Dist. of Columbia, Inc., et al.*, No. 15-cv-03315-RDB (D. Md. 2018); *Laboy v. Bd. of Trustees of Bldg. Serv. 32 BJ SRSP*, No. 11 Civ. 5127 (HB), 2012 BL 198316 (S.D.N.Y. 2012), *aff’d*, 513 F. App’x 78 (2d Cir. 2013); *Pugh v. Tribune*, 521 F.3d 686 (7th Cir. 2008); *Hickman v. Gem Ins. Co.*, 299 F.3d 1208 (10th Cir. 2002).