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In Hughes v. Northwestern University, SCOTUS Nudges Defined Contribution Plans Further into the Fray

By Jose M. Jara and Sheldon S. Miles*
Fox Rothschild LLP
Morristown, NJ

On January 24, 2022, the U.S. Supreme Court in *Hughes v. Northwestern University*¹ unanimously (8-0, Justice Barret took no part) ruled in favor of participants holding that to state a plausible claim under Employee Retirement Income Security Act (ERISA),² a context-specific inquiry is required as to whether fiduciaries continuously monitored the investment options in a defined contribution plan and removed imprudent ones. Since the Seventh Circuit Court of Appeals did not use this standard, the Court vacated and remanded its prior decision.³

The case garnered significant attention from the employee benefits community who viewed this case

* José M. Jara, counsel at Fox Rothschild LLP, focuses his practice on ERISA and employment litigation and counseling, including representing clients under investigation by the Department of Labor Employee Benefits Security Administration and defending them from lawsuits alleging violations of ERISA.

Sheldon S. Miles is an associate in the Employee Benefits and Compensation Group of Fox Rothschild LLP. He counsels clients with implementing and maintaining their employee benefit programs, such as 401(k) plans, pensions, and non-qualified deferred compensation arrangements. Additionally, Mr. Miles has experience with representing clients in excessive fee class action lawsuits.

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¹ No. 19-1401, 2022 BL 22257 (U.S. Jan. 24, 2022).

² Pub. L. No. 93-406.

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

as a potential antidote to the wave of excessive fee cases.⁴ The Court's decision is disappointing to many plan sponsors and fiduciaries of defined contribution plans, leaving them to navigate ERISA's "Sargasso Sea of obfuscation"⁵ without much guidance. It remains unclear as to whether this decision will likely lead to more "excessive fee" litigation across the country. However, within days of the decision, several district courts have denied fiduciaries' motions to dismiss and allowed those cases to proceed to the next stage of litigation.⁶

⁴ Jose M. Jara, *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); Jose M. Jara, Richard Lynn, and Sheldon S. Miles, *Oral Arguments in the Hughes v. Northwestern ERISA Excessive Fee Case*, 50 Tax Mgmt. Comp. Plan. J. No. 1. (Jan. 7, 2022).

⁵ *Travelers Ins. Co. v. Cuomo*, 14 F.3d 708, 717 (2d Cir. 1993) ("[T]he Supreme Court has described . . . ERISA . . . as 'not a model of legislative drafting.' In truth, it is a veritable Sargasso Sea of obfuscation:").

⁶ *Turpin and Johnson v. Duke Energy Corporation, et al.*, No. 3:20-CV-00528-KDB-DSC, 2022 BL 32672, at *4 (W.D.N.C. Jan. 31, 2022) ("While the ultimate truth of Plaintiff's allegations will be determined through discovery and further proceedings, Plaintiffs have alleged that Plan participants paid excessive recordkeeping and account management fees . . . and failed to adequately monitor the expenses charged to Plan participants. Therefore, Plaintiffs are entitled at this earliest stage of the case to an opportunity to pursue their claims."); *Shaw v. Quad/Graphics, Inc.*, No. 20-CV-1645-PP, 2022 BL 26119 at *1 (E.D. Wis. Jan. 26, 2022) ("Given the defendants' extensive reliance on *Divane* and other cases that applied similar categorical rules, the court will deny the defendants' motion without prejudice."); *Bangalore v. Froedtert Health Inc.*, No. 20-CV-893-PP, 2022 BL 26147 at *1-2 (E.D. Wis. Jan. 26, 2022) ("Given the defendants' extensive reliance on *Divane* and other Seventh Circuit cases that applied similar categorical rules, the court will deny the defendants' motion without prejudice."); *Goodman v. Columbus Reg'l Healthcare Sys., Inc.*, No. 4:21-CV-15 (CDL), 2022 BL 24373 at *3-4 (M.D. Ga. Jan. 25, 2022) ("The fact that Plaintiffs in this action had some lower cost index fund options is not dispositive of whether [defendant] satisfied its duty of prudence as a matter of law. Dismissing this claim would not comport with recent Supreme Court precedent." In addition, . . . [p]laintiffs allege that [defendant]'s recordkeeper received fees that were nearly double what a reasonable record-keeping fee would have been for a [comparable] plan and that

The Court's short opinion by Justice Sotomayor raises more questions than answers as many prevalent issues remain open, such as:

- Can a participant meet its burden at the pleading stage simply by alleging that recordkeepers should be compensated directly, through a flat fee, as opposed to revenue-sharing?
- Is it objectively unreasonable to offer retail class funds when the same investment options can be provided through institutional class shares at a lower share class?
- How many investments are deemed to be too many investments for participants to choose from?

THE HUGHES OPINION

The Plans

In *Hughes*, current and former employees of Northwestern University brought suit against the fiduciaries of two defined contribution plans — (i) the Northwestern University Retirement Plan; and (ii) the Northwestern University Voluntary Savings Plan. In a nutshell, the participants alleged in their complaint that the fiduciaries of both plans violated their fiduciary duty of prudence imposed under ERISA, which lead to significant losses for the participants and the plans as a whole. The prudent person standard, in part, 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.”⁷

Both plans at issue are 403(b) plans that allow for its participants to save for their personal retirement by deferring a percentage of their annual compensation into these plans for the purpose of investing contributions into one or more of the investment options assembled by the plans' fiduciaries. These investment options included: target-date mutual funds; index funds; actively managed funds; and a self-directed brokerage account.⁸ Prior to October 2016, over 400 investments were offered between these two plans. At

all times, participants had full discretion in selecting plan investments. Contributions were subject to gains and losses from investments as well as costs associated with investment management and plan administrative fees, such as recordkeeping costs. Here, the plans had two recordkeepers: Fidelity and Teachers Insurance and Annuity Association of America (TIAA).⁹ These recordkeepers were paid through the funds' expense ratios, which is commonly known as revenue-sharing. Participants in their amended complaint alleged that they paid substantially more for recordkeeping than they otherwise would have if recordkeeping costs were charged at an annual flat rate, such as \$35 per participant instead of through revenue-sharing.

How We Got Here

In 2018, the district court granted Northwestern's motion to dismiss. Deciding that the plans had an array of different investments for participants to choose from and therefore the fiduciaries were not required to invest in those funds that participants allege to be too expensive and underperforming.¹⁰ On appeal, the Seventh Circuit affirmed the district court's decision, and held that the investments that were preferred by the participants were in fact offered under both plans and that the participants were not forced to stomach an unappetizing menu of investments. Put another way, if the plaintiffs wanted to pay less in recordkeeping fees, they could have done so by choosing the investments in the plans with the lowest expense ratios. Likewise, if the plaintiffs wanted low-cost index funds, they could have invested in them since the plans had several index funds. The Seventh Circuit found support for their holding in *Hecker v. Deere & Co.*,¹¹ where there was no fiduciary breach of prudence since participants could invest in over 20 different investment funds and had access to over 2,500 mutual funds through a brokerage window.

The Decision

At issue before the Supreme Court was whether the participants in the Northwestern plans sufficiently pled a claim that Northwestern violated the fiduciary duty of prudence by:

- (a) Failing to monitor and control recordkeeping fees, resulting in unreasonably high costs to plan participants;

[defendant]'s recordkeeper received additional indirect compensation that was excessive. . . . Taking these allegations as true and drawing all reasonable inferences in Plaintiffs' favor, the Court finds that the complaint adequately alleges that [defendant] breached its duty to prudently manage administrative costs.”)

⁷ ERISA 404(a)(1)(B).

⁸ *Divane v. Northwestern Univ.*, 953 F.3d 980, 983 (7th Cir. 2020).

⁹ *Divane*, 953 F.3d at 990.

¹⁰ *Divane v. Northwestern Univ.*, No. 16-C-8157, 2018 BL 186065 (N.D. Ill. May 25, 2018).

¹¹ 556 F.3d 575, 586 (7th Cir. 2009).

(b) Offering investments in the form of “retail share classes” that charged higher investment fees than those otherwise charged by identical share classes of the same investments; and,

(c) Providing too many investment choices for participants.¹²

In their opinion, the Court did not directly address any of these questions but instead focused on its previous ruling in *Tibble v. Edison Int'l*,¹³ to reach its decision. The Court found that the Seventh Circuit solely concentrated on one component of the duty of prudence to compile a diverse menu of investment options¹⁴ and ignored that the duty of prudence also requires fiduciaries to continuously review plan investments and remove imprudent ones.¹⁵

This duty is derived from the Court’s decision in *Tibble*, where the participants argued that the fiduciary duty of prudence was breached because the 401(k) fiduciaries offered six high cost retail mutual funds when the same investments were available as lower priced institutional class mutual funds,¹⁶ and thus the participants would have had higher investment returns if they did not pay so much for administrative costs. In *Tibble*, the Court noted “[a] trustee must ‘systematic[ally] consider all the investment of the trust at regular intervals’ to ensure that they are appropriate.”¹⁷ The Court in *Hughes* noted, as in *Tibble*, that ERISA is derived from the common law of trust and under trust law a trustee has a continuing duty to monitor investments and to remove imprudent ones.¹⁸ However, the Court, in *Tibble*, stated that it expresses no view on the scope of a fiduciary’s duty, that is “just what kind of review [is] required?”¹⁹ Similarly, the Court, in *Hughes*, was silent on the scope.

The Court vacated and remanded the Seventh Circuit’s decision back to the Seventh Circuit to determine if the participants plausibly alleged, as a whole, a violation of the duty of prudence based on the standards set forth in *Tibble* and in accordance with the

pleading standard set forth in *Ashcroft v. Iqbal*,²⁰ and *Bell Atlantic Corp. v. Twombly*,²¹ The Court noted that this inquiry is context-specific,²² which means that the prudent person test under ERISA 404(a)(1)(B) is judged under the circumstances then prevailing. More importantly, the Court acknowledged that fiduciaries have to make difficult tradeoffs at times and “courts must give due regard to the range of reasonable judgments a fiduciary may make based on her experience and expertise.”²³

TAKEAWAYS

Class action lawsuits continue to be filed against ERISA fiduciaries for damages for excessive investment fees and/or recordkeeping and administrative service fees. The Supreme Court decision provides not much guidance or bright-line rules for ERISA fiduciaries to follow, and the lower courts are continuing to wrestle with claims that are often cookie-cutter complaints filed across the country.

Congress has not taken a position on this issue. The Congressional Research Service recently suggested that Congress could “consider further defining the scope of these obligations in legislation, including with respect to how fiduciaries should evaluate the level of fees associated with a particular investment. Alternatively, Congress could explore legislation that addresses a plan participant’s burden of proof for bringing a viable claim against a plan fiduciary relating to alleged excessive fees.”²⁴ Any future decision made by Congress will need to address the competing interests of protecting participants while also continuing to incentivize employers to voluntarily establish retirement plans for future employees by not making it so administratively cumbersome.²⁵

So what’s a fiduciary supposed to do? Invest in the cheapest passive investment. Not so fast and not nec-

¹² *Hughes v. Northwestern University*, No. 19-1401, 2022 BL 22257 (U.S. Jan. 24, 2022).

¹³ 575 U.S. 523 (2015).

¹⁴ The purpose of the broad range of alternatives, according to the U.S. Department of Labor, “is to enable participants . . . to achieve various levels on the risk and return spectrum while at the same time minimizing the risk presented by their portfolio. . . .” Final Regulation Regarding Participant Directed Individual Account Plans (ERISA Section 404(c) Plans), 57 Fed. Reg. 46,906, 46,920 (Oct. 13, 1992).

¹⁵ *Hughes*, 2022 BL 22257.

¹⁶ *Tibble*, 575 U.S. 523.

¹⁷ *Tibble*, 575 U.S. at 529.

¹⁸ *Hughes*, 2022 BL 22257 at *4.

¹⁹ *Tibble*, 575 U.S. at 530.

²⁰ 556 U.S. 662 (2009).

²¹ 550 U.S. 544 (2007).

²² *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 425 (2014) (in an ESOP case, the Supreme Court eliminated the presumption of prudence courts gave fiduciaries for investing in employer stock and finding that “[s]uch a rule does not readily divide the plausible sheep from the meritless goats. That important task can be better accomplished through careful, context-sensitive scrutiny of a complaint’s allegations.”).

²³ *Hughes*, 2022 BL 22257 at *5.

²⁴ Jennifer Staman, *Supreme Court Rules on Retirement Plan Fiduciary Duty in Hughes v. Northwestern University*, Congressional Research Service (Jan. 31, 2022).

²⁵ *Varity Corp. v. Howe*, 516 U.S. 489, 497 (1996) ([C]ourts may have to take account of competing congressional purposes, such as Congress’ desire to offer employees enhanced protection for their benefits, on the one hand, and, on the other, its desire not to create a system that is so complex that administrative costs, or litigation expenses, unduly discourage employers from offering . . . benefit plans in the first place”).

essarily so. According to the U.S. Department of Labor, fees should not be considered in a vacuum. Fees are only a “part of the bigger picture, including investment risks and returns[,] the extent and quality of services provided[, and diversification].”²⁶ Furthermore, “higher investment management fees do not necessarily mean better performance [and] . . . cheaper [is not] necessarily better.”²⁷ Fiduciaries have to also consider investment options with a long-term horizon of providing participants with sufficient investment returns for retirement.

For now, fiduciaries can issue request for proposals (RFPs) from service providers, such as recordkeepers and trustees. When conducting an RFP, fiduciaries need to compare the costs with the quality of the services being proposed. Typically, RFPs should be made every three to five years, and fiduciaries should document all decisions related to this process. Next, fiduciaries should evaluate and monitor the performance, costs, and diversification of the assets in their plans on a periodic basis. To monitor the investment fees and their performance, fiduciaries should select comparable industry benchmarks. Similar to the RFP process, all decisions should be documented.

²⁶ U.S. Dept. of Labor, A Look at 401(k) Plan Fees, p. 11 (Sept. 2019).

²⁷ See Note 26, above.

Fiduciaries may also want to adopt an investment policy statement that sets forth appropriate guidelines for selecting and monitoring investments and procedures for reviewing and removing imprudent investment options. Further, fiduciaries should review their fiduciary insurance coverage and should work with their insurer to increase coverage if it is below industry standards.

Lastly, fiduciaries may want to review their plan document and consult with ERISA counsel to consider whether to add an arbitration provision. Arbitration has certain benefits of being less costly than litigation and may provide a quicker resolution than litigating in the court room. On the other hand, decisions made through arbitration, generally, cannot be appealed and the pool of arbitrators to choose from may have less expertise and/or knowledge of ERISA than a federal judge. As with a variety of ERISA issues, courts around the country differ and have inconsistently applied mandatory arbitration clauses to ERISA cases. But a recent district court decision has granted defendant’s motion to compel arbitration.²⁸

²⁸ *Holmes v. Baptist Health South Florida, Inc.*, No. 21-22986-Civ-Scola, 2022 BL 19784 (S.D. Fla. Jan. 20, 2022) (the plan was a so-called 403(b) that allegedly did not monitor the performance or the fees of its investments).