Legislative and regulatory bulletin

401(k) litigation after the Supreme Court's Northwestern University decision

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Insights from recent appellate court rulings

Recently, hundreds of lawsuits have been filed against sponsors of 401(k) and other defined contribution (DC) plans claiming they breached their fiduciary duties under the Employee Retirement Income Security Act (ERISA). However, very few of those cases have gone to trial. Most have been dismissed by courts as being without merit; if the cases were not dismissed, the plan sponsor usually agreed to settle to avoid the costs and distractions of protracted litigation.

Rarely does a DC plan case go all the way up to the Supreme Court. But when one does, what the court has to say rightly commands the attention of plan sponsors, their investment advisors and their legal counsel, and becomes binding precedent on lower courts.

Hughes v. Northwestern University: The Supreme Court's ruling regarding Northwestern's 403(b) plan

On January 24, 2022, the Supreme Court issued its unanimous opinion in *Hughes v. Northwestern University,*[1] a case involving Northwestern's 403(b) plan. Among other things, plaintiff April Hughes and her fellow participants claimed that the plan's fiduciaries violated ERISA by selecting retail mutual funds instead of less costly institutional funds. The lower courts had dismissed the case, essentially ruling that the plan sponsor did not violate its ERISA fiduciary duties. Though the Supreme Court did not rule on the merits of the case, it did say that the lower courts had incorrectly applied the law, and it sent the case back down to the lower courts for reconsideration.

In their written opinion, the justices made it clear that fiduciaries have a duty to prudently select and monitor all investments on the DC plan menu and that failure to remove imprudent investments within a reasonable time is a violation of fiduciary duty. But they also acknowledged the challenges that ERISA fiduciaries face, noting "the circumstances facing an ERISA fiduciary will implicate difficult tradeoffs, and courts must give due regard to the range of reasonable judgments a fiduciary may make based on her experience and expertise."

[1] Hughes v. Northwestern University, 142 S.Ct. 737 (2022).

401(k) litigation: What appellate courts have said since the Northwestern decision

As of this writing, U.S. appellate courts have published three rulings since the Supreme Court handed down its opinion in the Northwestern University case. Below is a summary of how they addressed some of the alleged violations of fiduciary duty.

Active vs. passive funds. Several lawsuits claimed plan sponsors were imprudent by selecting a provider's suite of actively managed target date funds when that same provider also had a passively managed version. The participants claimed that the passive funds were less expensive and performed better over certain three-year and five-year periods. In affirming a lower court's dismissal of one of these cases, the 6th Circuit Court of Appeals held in *Smith v. CommonSpirit Health*[2] that the plan sponsor did not breach its fiduciary duties, noting:

> *"[Active funds] represent a common fixture of retirement plans, and there is nothing wrong with permitting employees to choose them in hopes of realizing above-average returns over the course of the long lifespan of a retirement account."*

> *"It's possible, indeed likely, that the absence of any actively managed funds suited for risk-tolerant investors would be imprudent."*

Target date fund investment performance. In the *CommonSpirit Health* case, the court rejected the participants' claim that recent underperformance of the active target date funds compared with the passive versions indicated the fiduciaries were imprudent in selecting and retaining them, saying:

> *"Merely pointing to another investment that has performed better in a five-year snapshot of the lifespan of a fund that is supposed to grow for fifty years does not suffice to plausibly plead an imprudent decision—largely a process-based inquiry—that breaches a fiduciary duty."*

> *"A side-by-side comparison of how two funds performed in a narrow window of time, with no consideration of their distinct objectives, will not tell a fiduciary which is the more prudent long-term investment option."*

Competitive bids. One of the claims the participants made in *Albert v. Oshkosh Corporation*[3] is that the plan sponsor caused the plan to pay excessive recordkeeping fees because it didn't regularly solicit competitive bids. The 7th Circuit Court of Appeals cited an earlier ruling in which it rejected the notion that the failure to get bids from service providers on a regular basis was a breach of fiduciary duty. The court noted that the Supreme Court's ruling in the Northwestern University case did nothing to change that conclusion, stating:

> *"[The Supreme Court] did not hold that fiduciaries are required to regularly solicit bids from service providers."*

Fiduciary investment decisions. Historically, courts have been reluctant to find fault with fiduciaries' investment decisions, even if in hindsight the investments they chose didn't perform as well as others. Rather, courts have looked to the process fiduciaries used to reach their decisions. If that process was deliberate and prudent, courts typically have concluded that the fiduciaries did not violate their duties under ERISA. In the *CommonSpirit* case, the court put it this way:

> *"[ERISA] does not give the federal courts a broad license to second-guess the investment decisions of retirement plans."*

Mutual fund "net expense" theory. The plaintiff in the *Oshkosh* case claimed that the plan's fiduciaries should have chosen classes of certain mutual funds with revenue sharing—which would have had higher expense ratios—because they would be less costly for participants once the revenue sharing was netted out and credited to participants' accounts. The court rejected this "novel" theory, noting:

[2]Smith v. Commonspirit Health (6th Circuit Opinion dated June 21, 2022).

[3]Albert v. Oshkosh Corporation, et al. (7th Circuit opinion dated August 29, 2022).

> *"No court has said that ERISA requires a fiduciary to choose investment options" [on the basis that the net expense of a higher cost share class] "would be lower in light of revenue sharing."*

Least expensive mutual fund share class. Over the years, many courts have dismissed claims that fiduciaries were imprudent by choosing a more expensive share class of a fund when a cheaper class of the same fund was available. They reasoned that the additional cost—which was usually attributable to revenue sharing—could have been used to pay for recordkeeping or credited back to participants. In *Forman v. TriHealth, Inc.,*[4] the 6th Circuit acknowledged there could be legitimate reasons for choosing more expensive share classes of the same fund. But the court ruled that it was premature to dismiss the case at the early stage of the lawsuit before hearing the evidence. In the words of the court:

> *"But the pleading stage, it is too early to make these judgment calls."*

The Supreme Court's Northwestern University ruling hasn't slowed the number of new DC plan fiduciary breach lawsuits being filed. But the appellate court decisions that have been issued since that ruling have resolved most of the participants' claims in favor of plan sponsors and continue to support the notion that a sound decision-making process is the best way for fiduciaries to defeat claims that they failed to live up to ERISA's standards.

[4] Forman v. TriHealth, Inc. et al. (6th Circuit opinion dated July 13, 2022).

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