Mitigating Fiduciary Risk: Lessons Learned About the Prudent Person Rule After Fifteen Years of Fee Litigation

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The uptick in lawsuits now commonly referred to as "excessive fee" fiduciary breach litigation began on September 11, 2006, when a St. Louis firm, Schlichter Bogard & Denton, filed its initial tranche of lawsuits against the fiduciaries of multiple large corporate 401(k) plans. In the fifteen years since those initial cases were filed, excessive fee lawsuits have become ubiquitous — at times numbering hundreds of cases filed per year — as more and more plaintiffs' firms enter this space. Many of the complaints in these cases are now formulaic, and plaintiffs have attacked fiduciaries of participant-directed retirement plans (401(k) or 403(b) plans) which range in size from tens of millions to multiple billions in assets. Plaintiffs in these excessive fee lawsuits commonly allege, among other claims, that plan fiduciaries breached their duty of prudence by failing to adequately monitor the cost and performance of their plans' investment options.

This excessive fee litigation has encouraged the reexamination of fiduciary best practices. Although the facts underlying these cases vary, the fundamental questions in each case pertain to the process by which the fiduciaries carried out their responsibilities. As courts have grappled with questions of fiduciary responsibility, a body of case law has developed that provides valuable guidance on methods plan fiduciaries may use to mitigate their risk if faced with a lawsuit or government investigation. This article addresses the duty of prudence in monitoring plan investments, thereby mitigating fiduciary risk through the lens of that body of case law.

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Prudent Person Rule

Section 404 of the Employee Retirement Security Income Act of 1974, as amended (ERISA) sets forth the primary responsibilities of an ERISA fiduciary. These responsibilities include the Prudent Person Rule, which is a primary focus in this excessive fee litigation. This rule requires that plan fiduciaries act with the care, skill, prudence and diligence under the then-prevailing circumstances that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character with like aims. Put simply, this rule requires that a plan fiduciary act like a reasonable fiduciary would act in the same circumstances.

In evaluating whether a fiduciary has breached its duty of prudence, courts focus on the merits of the transaction at issue (e.g., the selection, removal, or retention of an investment option) and the thoroughness of the fiduciaries' investigation into the merits of that transaction. Relying on this responsibility to support their claims, plaintiffs have challenged the inclusion of a subset of a plan's investment menu, alleging that the challenged funds are objectively overpriced in the market and did not perform in a manner that justified their cost.

Motions Challenging Plaintiffs' Common Claims

In most cases, fiduciaries have asked courts to dismiss claims based on the alleged imprudence of a plan's investment options through early motions to dismiss. To succeed on such a motion, fiduciaries must show that the plaintiffs' claims are legally insufficient (i.e., that plaintiffs have failed to plausibly allege that the fiduciaries acted imprudently). The decisions on those motions to dismiss have created a wide body of case law evaluating typical claims involving the investment funds' cost and performance — and have clarified certain fundamental principles of fiduciary oversight.

For example, it is common in these cases for plaintiffs to argue that plan fiduciaries offered too many actively managed investment options, because actively managed funds tend to carry higher investment management fees than passively managed index funds. In response to motions challenging the viability of these claims, courts have universally concluded that there is no requirement that plan fiduciaries offer any amount of passively managed options versus those that are actively managed.[1]

Likewise, courts have roundly agreed that the cost of a fund, alone, cannot demonstrate its imprudence and that the existence of a less expensive fund is not evidence of imprudence. Plan fiduciaries are not required to scour the market for the cheapest possible options and may offer funds for reasons other than cost.[2]

In order to even state a viable imprudence claim, courts have found that plaintiffs must plausibly allege that the challenged funds were not only overpriced but also performed poorly compared to a viable benchmark. To support their underperformance claims, plaintiffs typically rely on data that overemphasizes periods of comparative underperformance by cherry-picking fixed points in time that fit with their claims (i.e., those that include lower relative returns). Courts are increasingly dismissing claims based on these types of self-serving hindsight performance allegations and have reaffirmed that fiduciaries may measure performance based on long-term periods.[3]

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Two Bench Trials Evaluate Prudence Process

Decisions reached after two rare bench trials in the *Sacerdote v. New York University*, 328 F.Supp.3d 273, 283 (S.D. N.Y., 2018) and *Wildman v. American Century Services, LLC*, 362 F. Supp. 3d 685 (W.D. Mo., 2019) cases provide valuable insight into what courts consider to be a prudent process.

In *NYU*, the court issued an order in favor of the defense following an eight-day bench trial. In reaching its decision, the court looked not only to the fiduciaries' investigation procedures, "but also to the methods used to carry out those procedures as well as the thoroughness of their analysis of the data collected in that investigation." The court found that the NYU investment committee was comprised of nine high-ranking employees who met quarterly and were advised by an expert investment manager. This investment advisor provided the NYU committee with materials on various financial aspects, which were typically distributed to committee members ahead of their meetings, and which the committee members reviewed. It also found that committee members asked the advisor questions and were provided with recommendations.

The court in *NYU* cautioned that committee members should not blindly rely on their advisor's counsel and should be familiar with the basic concepts relating to the plans. The committee, the court found, was required to independently verify the quality of the investment advice it received. While the court found that the "level of involvement and seriousness" that many of the committee members exhibited was potentially lacking, it concluded that between the advice provided by the investment advisor "and the guidance of the more well-equipped Committee members," the committee performed its role adequately.

In *American Century*, the district court issued a decision in the fiduciaries' favor after an eleven-day bench trial. In reaching its decision, the district court found that the American Century plan offered a large number of investment options that consisted *entirely* of funds that American Century managed; and, between 2013 and 2016, the plan offered no passively managed options. Such facts are rife with potential litigation risk, as claimants in these lawsuits commonly allege that fiduciaries breached their duties by retaining any proprietary funds or an insufficient amount of typically lower-cost indexed investments.

The district court, however, looked past these potentially unfavorable facts to the American Century committee's process in overseeing the plan's investment menu. The court found that, upon being appointed to the committee, members received training about their fiduciary duties and were provided with plan documents and the plan's investment policy statement (IPS). The court found that the committee met regularly, at least three times per year, and that the meetings were active and productive. In rendering its decisions, the committee was guided by its IPS, which provided guidelines for fees and performance metrics. The committee considered those factors, along with expert information provided by its investment advisor and other consultants, while making its decisions about the plan's investment options.

Notably, the court specifically found that the American Century committee's IPS did not *require* the committee to remove a fund for failure to obtain certain metrics, but instead provided guidelines that gave the committee broad discretion to make decisions using their investment expertise.

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The court looked to the "totality of the circumstances" because the "critical question is whether the defendants took into account all relevant information in performing [their] fiduciary duty under ERISA." Taking this information into consideration, the court concluded that the plan's fiduciaries did not act imprudently by offering only American Century funds and, for a time, no passively managed funds. The court held that the plan's fiduciaries did not act imprudently, because they appropriately considered whether to add, remove, or retain the plan's options.

Mitigating Risk

Decisions on early motions in excessive fee lawsuits tell us that a plan's investment funds need not be the cheapest on the market, that cost alone cannot demonstrate imprudence of an investment fund, and that performance should be evaluated on a long-term basis. Even in cases involving practices that would tend to carry high risk (such as *American Century*), courts still looked to the overall functioning of the committees' process in determining that the fiduciaries had not acted imprudently.

From these cases, we see that courts have recognized a prudent process in which administrators set up formal committees with active, interested and invested committee members. Plan fiduciaries are not required to be investment experts and may rely on the expertise of their investment advisors and other more investment-savvy committee members. Committees should meet regularly, at least 2–3 times per year; and committee members should receive and review investment review materials ahead of the meetings, thoroughly review those materials, ask questions of the committee's investment advisor to ensure full understanding of the materials, and render informed decisions about the plan's options. In addition, committee decisions should be guided by a well-drafted IPS that provides fiduciaries with broad discretion to render their decisions within a reasonable framework.

Importantly, plan fiduciaries should seek advice regarding their fiduciary duties and best practices on a regular basis. This should include routine education and regular engagement with experts on developing fiduciary standards and best practices. Once fiduciaries understand these fundamental aspects of a properly functioning committee, they will be equipped to put practices in place to solidify and follow processes that courts in this litigation have deemed prudent. This proper functioning should be well-documented — in minutes from committee meetings held at regular intervals and other materials — so that, should the fiduciaries ever face litigation, they are prepared to demonstrate their prudent practices.

It is uncertain where the focus of excessive fee litigation will lead as more and more plans are targeted in such cases, but the pace of the filings has not diminished. Notably, on July 2, 2021, the United States Supreme Court granted certiorari in *Divane v. Northwestern University*, No. 18-2569 (7th Cir. 2020), a case often cited by fiduciaries in these cases to support their defense. The issues that the Court has agreed to consider in *Divane* are broad, and its decision could have a significant impact on this area of litigation. Nevertheless, what these cases teach us is that, by implementing proper processes — and instituting best practices for the benefit of their plans' participants — plan fiduciaries may build effective defenses to fiduciary breach claims.

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[1] *See White v. Chevron Corp.*, 752 F. App'x 453 (9th Cir. 2018); *Martin v. CareerBuilder, LLC*, No. 19-CV-6463, 2020 WL 3578022 (N.D. Ill. July 1, 2020); *Dorman v. Charles Schwab Corp.*, No. 17-00285-CW, 2018 WL 6803738 (N.D. Cal. Sept. 20, 2018); *Divane v. Northwestern Univ.*, 953 F.3d 980, 991 (7th Cir. 2020).

[2] See, e.g., *Wehner v. Genentech, Inc.*, No. 20-CV-06894-WHO, 2021 WL 507599 (N.D. Cal. Feb. 9, 2021); *Meiners v. Wells Fargo & Co.*, 898 F.3d 820 (8th Cir. 2018); *White,* 752 F. App'x 453.

[3] *Anderson v. Intel Corp. Inv. Policy Comm.*, No. 19-CV-04618-LHK, 2021 WL 229235 (N.D. Cal. Jan. 21, 2021).

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