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Legal Sidebar

Supreme Court to Weigh in on Retirement Plan Fiduciary Duty to Manage Plan Fees

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Among Congress's key policy priorities is safeguarding retirement income security for working Americans, retirees, and their families. With respect to oversight of 401(k) and similar employment-based retirement plans, a primary consideration is the fees charged to plan participants, as fees can have a substantial effect on a participant's retirement savings amount. In July 2021, the Supreme Court agreed to hear *Hughes v. Northwestern University*, a case concerning the scope of a plan fiduciary's duty to control retirement plan fees under the Employee Retirement Income Security Act (ERISA), and the circumstances under which participants and others can sue plan fiduciaries for a breach of this duty. This Legal Sidebar provides background on ERISA's requirements for retirement plans and plan fiduciaries, discusses the issues before the Court in *Hughes*, and concludes with select legal considerations for Congress.

Background

ERISA provides a comprehensive federal scheme for regulating private-sector employee benefit plans. The Act governs approximately 722,000 retirement plans that contain more than $9 trillion in plan assets. ERISA does not require employers to offer retirement benefits, but those that do must comply with the Act's requirements.

The *Hughes* case involves a so-called 403(b) plan, a 401(k)-like defined contribution plan used by certain educational institutions and tax-exempt organizations. As part of this retirement plan type, each participant has an individual account containing an amount based on employer and employee contributions and investment gains or losses to the account, minus fees or other plan expenses. Defined contribution plans do not provide a guaranteed benefit amount, and participants' account balances generally fluctuate over time. Plan fiduciaries typically compile a menu of investment options, and plan participants may choose investments from this menu.

One of ERISA's central goals is to "protect . . . the interests of participants and . . . beneficiaries" of employee benefit plans. To this end, ERISA imposes certain obligations on plan fiduciaries—persons who generally have discretionary authority or control over the management and operation of employee benefit plans. Among these obligations, ERISA requires fiduciaries to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man . . . would use in the conduct of an enterprise of a like character and with like aims." The Supreme Court has recognized that in making investment-related decisions for a plan, this duty of prudence applies to both the initial selection and ongoing monitoring of the investments within retirement plans.

ERISA fiduciaries must also manage plan expenses that plan participants pay. While the Act does not specify a level of fees that may be paid through a defined contribution plan participant's account, fiduciaries must ensure that plan fees are "reasonable." Additionally, under ERISA, participants and government entities can bring various civil actions to enforce the Act's fiduciary requirements. Among other provisions, the Act authorizes the Secretary of Labor, a plan participant, and others to bring a civil action to redress a breach of fiduciary duty. ERISA makes a plan fiduciary personally liable for breaches against a plan.

Recently, there has been extensive litigation over whether defined contribution plan fiduciaries imprudently selected or failed to monitor plan investments with "excessive fees" that underperformed alternative, lower-priced investments. Excessive fee litigation has also involved legal challenges relating to plan service providers and claims that fiduciaries improperly paid exorbitant amounts to providers to administer 401(k) or other defined contribution plan benefits. In these cases, plan participants have alleged that plan fiduciaries breached their duties by paying unnecessarily high recordkeeping and/or investment management fees and expenses, which substantially lowered the participants' retirement account balances. Dozens of fee-related cases were filed last year alone, and some litigating parties have reached multimillion dollar settlements. Beginning around 2016, there has been a swell of excessive fee litigation involving 403(b) plans in particular. Several lawsuits have been filed against universities on behalf of more than 470,000 plan participants.

Hughes v. Northwestern University

In *Hughes* (formerly captioned *Divane v. Northwestern University*), employees participating in at least one of the University's two 403(b) plans filed a class action lawsuit against the educational institution and certain university officials, claiming, among other things, that plan fiduciaries imprudently paid excessive recordkeeping and investment management fees. Plan fees were collected in the form of an expense ratio (i.e., a percentage of the plan's assets) to cover recordkeeping and investment management costs. Given that the plans jointly held more than $3 billion in net assets, participants generally contended that plan fiduciaries failed to employ certain methods available to larger plans to reduce plan expenses.

Plan participants alleged that the fiduciaries breached their obligations by paying recordkeeping expenses as part of the expense ratio, rather than a flat, per-participant amount. (According to the participants, a "reasonable" annual rate for recordkeeping fees would have been $35 per participant, and participants paid approximately $54 to $87 per year for one of the University's plans and an average of $153 to $213 per year for the other.) Plan participants argued that had fiduciaries wielded their bargaining power and negotiated a per-participant fee arrangement, recordkeeping expenses could have been millions of dollars less. Participants further claimed that the fiduciaries imprudently chose investment options with "unnecessary" management fees in the plans' investment lineup. In particular, participants challenged the fiduciaries' selection of certain "retail-class" mutual funds, when identical "institutional class" fund shares were available to large investors at lower prices.

The district court dismissed participants' claims for failing to demonstrate a plausible ERISA violation, and the U.S. Court of Appeals for the Seventh Circuit affirmed the judgment. With respect to recordkeeping expenses, the appeals court rejected the participants' claims in part because, in the court's view, ERISA does not require a per-participant fee structure, fiduciaries were not obligated to search the market for a low-cost recordkeeper willing to accept the per-participant amount, and plaintiffs failed to show how this hypothetical recordkeeper would best serve participants. The appeals court also pointed out that the plaintiffs had the opportunity to keep recordkeeping expenses low by choosing to invest in certain low-cost index funds that were also available under the plan.

With respect to the fiduciaries' decision to offer certain mutual funds that carried higher management fees, the appeals court also determined that participants did not allege a breach of fiduciary duty. As the court explained, lower-cost investment options were offered under the plan, and plaintiffs were not "forced to stomach an unappetizing menu." The court explained that in concert with earlier Seventh Circuit decisions, plans may generally offer a broad array of investment options and fees without breaching fiduciary responsibilities under ERISA. Participants then petitioned the Supreme Court to hear their case, and the Court granted review. Oral arguments have yet to be scheduled, but the Court will likely hear the case during its October 2021 term.

Considerations for Congress

At issue in the *Hughes* case are questions about what ERISA fiduciaries must do to limit expenses under an ERISA plan. A forthcoming Supreme Court decision in *Hughes* could provide clarity as to whether plan participants may bring a fiduciary breach claim, particularly in a situation in which a plan offers an array of investment options beyond the products associated with allegedly excessive fees. In a 2015 ERISA decision, the Court mentioned that under *trust law* (upon which ERISA fiduciary duty is based), a fiduciary "has a continuing duty to monitor investments and remove imprudent ones." However, the Court's ruling in the earlier case focused on the time period for filing suit against an ERISA plan fiduciary, and not the scope of an ERISA fiduciary's duty to weed out allegedly imprudent investments from a retirement plan with broader investment offerings. In *Hughes*, the Court may also provide insight on the use of an expense ratio for calculating fees in ERISA plans, or a plan fiduciary's duty to seek out institutional-class mutual funds or other investments carrying lower fees, particularly if a plan covers a large number of participants.

Should Congress decide to address the issue of plan fiduciary obligations, it could consider further defining the scope of these obligations, 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. Such legislation could also alter the ability of plan participants to bring claims in these types of cases.

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