The Asset Management Industry
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Seventh Circuit Issues Decision After Reconsidering 403(b) Plan Fee Case

[35253]

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TO: ICI Members
Pension Committee
Pension Operations Advisory Committee SUBJECTS: Pension RE: Seventh Circuit Issues Decision After Reconsidering 403(b) Plan Fee Case

On March 23, 2023, the Seventh Circuit Court of Appeals issued a new decision (attached) reexamining Hughes v. Northwestern, a plan fee case on which the US Supreme Court opined in 2022 and remanded back to the Seventh Circuit.[1] The case relates to the investment lineup and fees in two 403(b) plans and whether the plaintiffs stated a plausible claim for relief against the plan fiduciaries for breach of the duty of prudence.

Upon its reconsideration, the Seventh Circuit ruled that two of the plaintiffs' three claims could continue, surviving the motion to dismiss.

Background

The plaintiffs (participants in two 403(b) plans sponsored by Northwestern University) alleged that Northwestern University (and the Retirement Investment Committee) breached their duty of prudence under ERISA, by "paying excessive recordkeeping fees" and "offering mutual funds with excessive investment management fees." More specifically on this point, the plaintiffs allege that the plans offered a number of mutual funds in the form of retail share classes, instead of otherwise identical institutional share classes. The plaintiffs also complain that they had too many investment options (over 400, for part of the time period at issue) to choose from, which they allege caused participant confusion and poor investment decisions.

The district court dismissed the complaint for failure to adequately plead a breach of the fiduciary duty of prudence, noting that low-cost index funds were available under the plans and that the Seventh Circuit has held that using revenue-sharing to pay for plan expenses does not violate ERISA.

The Seventh Circuit affirmed the dismissal, which the plaintiffs appealed. In January 2022, the US Supreme Court, by a unanimous vote of 8-0, vacated the Seventh Circuit's dismissal of the case and remanded the case for reconsideration.

The Supreme Court characterized the Seventh Circuit's holding as follows: "petitioners' allegations fail as a matter of law, in part based on the court's determination that petitioners' preferred type of low-cost investments were available as plan options. In the court's view, this eliminated any concerns that other plan options were imprudent."[2] The Supreme Court disagreed with this conclusion, pointing to language in its 2015 opinion in Tibble v. Edison Int'l,[3] affirming that a fiduciary has a continuing duty to monitor plan investments and remove imprudent ones. It explained that the Seventh Circuit's "categorical rule is inconsistent with the context-specific inquiry that ERISA requires."[4] The opinion reaffirms the principle from Tibble that the court must look at the specific allegations and circumstances in order to determine whether the complaint plausibly alleges a breach of fiduciary standard based on keeping poorer-performing/higher-cost options on the plan lineup.

New Seventh Circuit Opinion

Tasked with reexamining the case as directed by the Supreme Court, the Seventh Circuit (hereinafter, the "court") reassessed the pleading standard and applied it to plaintiffs' three claims.

Analysis of Precedent

The court began its analysis by reviewing the status, after the Supreme Court's decision in Hughes, of prior Seventh Circuit excess fee precedent.[5] While the Supreme Court rejected the reliance on a "wide range of expense ratios" in a plan to dismiss a claim that a plan fiduciary provided investment options with excessive fees, the Seventh Circuit observes that Hughes left untouched the following three principles from Loomis and Hecker.

- The use of revenue sharing for plan expenses does not amount to a per se violation of fiduciary duty under ERISA. But this principle does not excuse plan fiduciaries from their continuing duty to monitor their expenses to make sure that they are not excessive with respect to the services received.
- "[N]othing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund."[6] In discussing this principle, the court reaffirms "that a fiduciary need not constantly solicit quotes for recordkeeping services to comply with its duty of prudence." This principle does not, however, address the duty of a fiduciary when it has access to a cheaper but otherwise identical fund from the same fund provider.
- Plans may generally offer a wide range of investment options and fees without breaching any fiduciary duty.

Articulation of Pleading Standard

After its review of Hughes' impact on Seventh Circuit precedent, the court next discussed the pleading standard for a breach of the duty of prudence under ERISA, noting that the Supreme Court "offers some guidance but stops short of pronouncing a concrete standard." In the last sentence of Hughes, the Supreme Court stated that "[a]t times, 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."

Northwestern had argued for an interpretation of the Supreme Court's opinion that would apply Dudenhoeffer's[7] heighted pleading standard (namely that "a plaintiff must plausibly allege an alternative action that the defendant could have taken … that a prudent fiduciary

in the same circumstances would not have viewed as more likely to harm the fund than to help it.").[8] The court disagreed, finding instead that the Supreme Court intended for Dudenhoeffer's heightened pleading standard to apply only to breach of duty of prudence claims alleged against fiduciaries who manage ESOPs. Instead, it found that the Supreme Court had directed it to apply the pleading standard discussed in Iqbal and Twombly. The court articulated the following standard.

> To plead a breach of the duty of prudence under ERISA, a plaintiff must plausibly allege fiduciary decisions outside a range of reasonableness. How wide that range of reasonableness is will depend on "'the circumstances ... prevailing' at the time the fiduciary acts." The discretion accorded to an ERISA fiduciary "will necessarily be context specific." (citations omitted). [9]

The court explained that, at the pleadings stage, a plaintiff must provide enough facts to show that a prudent alternative action was plausibly available, rather than actually available. Further, where alternative inferences are in equipoise—that is, where they are all reasonable based on the facts—the plaintiff is to prevail on a motion to dismiss.[10]

Analysis of the Three Claims

Once it had articulated the applicable pleading standard, the court applied it to the three claims: that Northwestern (1) failed to monitor and incurred excessive recordkeeping fees, (2) failed to swap out retail shares for cheaper but otherwise identical institutional shares, and (3) retained duplicative funds.

Regarding the recordkeeping fees claim, the court highlighted plaintiffs' allegations that recordkeeping services are fungible and that the market for them is highly competitive; that that the fees were excessive relative to the recordkeeping services rendered; and that several other university 403(b) plans had successfully reduced recordkeeping fees by soliciting competitive bids, consolidating to a single recordkeeper, and negotiating rebates. The court also noted the fact that, subsequently, Northwestern had successfully lowered the plans' administrative fees (including recordkeeping fees), "which suggests that Northwestern's recordkeeping fees were unreasonably high and that means to lower such fees were available."[11] Under the pleading standard it articulated, the court found that plaintiffs had pleaded sufficient facts to render it plausible that Northwestern incurred unreasonable recordkeeping fees and failed to take actions that would have reduced such fees.

Regarding the share-class claims, the court noted the similarity between the plaintiffs' allegations—that Northwestern retained more expensive retail-class shares of 129 mutual funds when, by using Northwestern's size and correspondent bargaining power, less expensive but otherwise identical institutional class shares were available to the plans—and those in Tibble. Northwestern argued that access to institutional-class shares often requires significant minimum investment and that plaintiffs had not pleaded that institutional-class shares were actually available to the plans. Rejecting this argument, the court found that the plaintiffs were required to show only that such cheaper institutional shares were plausibly available.

Regarding the claim that Northwestern breached its duty of prudence by retaining multiple duplicative funds, and that the excessive options in the plans caused "decision paralysis" and led to investor confusion, the court affirmed its prior dismissal of the claim. The court noted that the Supreme Court opinion in Hughes did not alter the principle that unspecific

allegations that a fiduciary provided too many funds, without more, do not state a claim for breach of the duty of prudence.

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Notes

[1] For an overview of the Supreme Court decision, see ICI Memorandum No. 34008, dated January 25, 2022, available at https://www.ici.org/memo34008. ICI had filed an amicus brief in the case, urging the Court to affirm the Seventh Circuit's decision and clarify for the lower courts that its well-established and common-sense pleading standards apply to excessive fee cases. See ICI Memorandum No. 33879, dated November 2, 2021, available at https://www.ici.org/memo33879. In November 2022, ICI filed an amicus brief in Matney v. Barrick Gold (10th Circuit Court of Appeals), addressing a number of the same issues ICI addressed in the amicus brief in Hughes. Our brief explained, and as the Supreme Court affirmed in Hughes v. Northwestern University, ERISA affords fiduciaries significant discretion to not only select an appropriate mix of investment options for participants, but to structure the plan in a way that fairly and efficiently provides for payment of third-party services (such as recordkeeping fees). See ICI Memorandum No. 34345, dated November 9, 2022, available at https://www.ici.org/memo34345.

[2] See page 1 of Hughes opinion, 142 S. Ct. 737 (2022), available at https://www.supremecourt.gov/opinions/21pdf/19-1401_m6io.pdf.

[3] 575 U. S. 523 (2015).

[4] See page 2 of Hughes opinion.

[5] The court primarily references Loomis v. Exelon Corp., 658 F.3d 667, 673-74 (7th Cir. 2011), and

Hecker v. Deere & Co., 556 F.3d 575, 586 (7th Cir. 2009).

[6] Page 11 of opinion, the quoting language from Hecker and Loomis.

[7] Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409 (2014).

[8] Page 15 of opinion, quoting Dudenhoeffer.

[9] Page 20 of opinion.

[10] Page 19 of opinion.

[11] Page 25 of opinion.

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