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Hughes v. Northwestern University

A Message to Fiduciaries From the Supreme Court

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I. INTRODUCTION

"That reasoning was flawed." With those four words, the Supreme Court of the United States reaffirmed that retirement plan fiduciaries' responsibilities apply independently to each investment option.[i] Offering a lot of investment options does not eliminate the responsibility related to each of them. Offering some cheap investment options does not excuse expensive ones. Offering some stronger performers does not excuse poor performers. The bad stuff is not okay simply because there's also some good stuff.

The Court made this position clear in *Hughes v. Northwestern University*[ii]. *Hughes* did not break new ground; it reminded us that the ground is already established. In fact, as the Court reminded us with confident reliance on its 2015 opinion in *Tibble v. Edison International*[iii], the ground is *clearly* established. When the Court delivers a unanimous opinion in today's environment – as it did in both *Tibble* and *Hughes* – we should take notice.

Plan fiduciaries, in particular, should take notice. For most plan fiduciaries, *Hughes* is one of two extremely different things: (i) not a big deal at all; or (ii) a really big deal. This White Paper will help plan sponsors and their responsible plan fiduciaries to assess whether it's the former or the latter. In either scenario, this White Paper provides a set of best practices for identifying, understanding, and mitigating related risks.

II. UNDERSTANDING THE TERMINOLOGY

Retirement plan fee litigation has ramped up dramatically over the last 15 years. The pace is accelerating on the other side of the pandemic and as the plaintiffs' firms have learned how to assert more convincing allegations and to more strongly support the allegations with data and other circumstantial evidence. Much of the litigation hinges upon terms that merit a brief exploration before we turn to *Hughes*: share classes, retail shares, institutional shares, revenue sharing, and collective investment trusts.

A. Share Classes

To best understand share classes, we begin with an acknowledgement that buying power creates leverage, which leads to price concessions. Consider the following hypothetical scenario:

- Assume for a moment that you establish a mutual fund, set the expense ratio (cost), and invite your neighbor to invest $10,000 in the fund.
- Further assume that another neighbor hears about your fund and expresses a desire to invest $100,000. Before doing so, though, she asks for a lower price. She's smart and argues that you don't have to do ten times as much work to put her investment to work, so she wants a price break.

- Finally, a fourth neighbor's company maintains a $10 million 401(k) plan and would like to make your fund available to the plan participants. Fortunately for those employees, the plan's ERISA 3(38) fiduciary investment manager understands buying power and argues for an even cheaper version. She wants the plan to have access to "institutional pricing" instead of "retail pricing".

Most money managers would like to gain all four clients identified above, especially the latter three. The managers also are willing to offer different price points corresponding to different minimum investment levels to reflect that each potential client has a different degree of leverage and due to economies of scale (that is, they recognize there is not a linear relationship between each extra dollar invested and the additional work required). In order to offer different versions, money managers establish "share classes", which are identical but for one aspect: the expense ratio.

B. Retail v. Institutional Share Classes

It is common for the financial industry to divide the types of share classes into two broad categories: (1) retail shares, which would most likely be appropriate for the first three individuals identified above; and (2) institutional shares, which would reflect that a large employer-sponsored retirement plan is more "institutional" than the other "retail" investors. With that said, a fund manager may create many more than two share classes.

It designates the different share classes by adding some sort of indicator on the end of the fund name, frequently "R" for retail or "I" for institutional, but commonly also using "A", "Z", O", "Adm", "Inv", among others. When there are multiple retail share classes, the manager might combine the capital letter with a number, such as R2, R3, R4, R5, and R6, with those progressing to a cheaper share class as the number gets larger. A practical example of the various retail share classes arises in a lawsuit we will discuss below, in which the participants argue that the plan fiduciary should have used the cheaper R6 share class instead of the more expensive R5 share class.

C. Revenue Sharing

Recordkeepers do not work for free. They are for-profit entities that serve a valuable role in the US retirement system. They need revenue to support their recordkeeping and administrative services. One might think that they would simply charge the end user (the participant) for those fees. History tells a different story.

Let's continue with the hypothetical scenario described above. Your mutual fund has become more popular and you would like it to be made available to retirement plans maintained by Recordkeeper X. You are pessimistic about your chances because Recordkeeper X is also a money manager that maintains its own mutual funds. You realize that the best way for you to gain access to Recordkeeper X's plans is for you to offer to share some of the revenue generated by the expenses associated with your mutual fund. Of course, it is easier for you to share revenue with the recordkeeper when a plan uses a more expensive share class.

Recordkeeper X is motivated to permit – if not encourage – the use of share classes that generate revenue sharing for four reasons:

(1) It creates revenue that can be shared with – or kicked back to – the recordkeeper.

(2) Collecting fees via revenue sharing allows for the impression that plan participants are not paying a fee for the recordkeeping and administrative services. Recordkeepers like this. Many plan sponsors do, too. (Spoiler alert: the Department of Labor and many Federal courts do not.)
(3) This creates less transparency, which frequently leads to less accountability around the reasonableness of the recordkeeper's fees.
(4) In fact, it aligns with recordkeepers' preference for fees to be expressed as a percentage instead of a flat dollar amount because over time the recordkeeper's revenue increases as the total plan assets increase. Higher revenue without corresponding extra work results in higher margins and greater profitability for recordkeepers.

This structure serves the interests of the recordkeepers and plan sponsors, but not participants. A little over 15 years ago, plaintiffs' firms figured out that far too many employer-sponsored retirement plans were not using institutional share class options. The firms began the barrage of lawsuits that have ramped up transparency, compressed fees, and resulted in a more competitive recordkeeping environment. With hundreds of lawsuits, numerous settlements, favorable verdicts for plaintiffs, and the ERISA 408(b)(2) fee disclosure regulations, one might have expected these share class and revenue sharing issues to dry up. That simply hasn't happened.

D. Collective Investment Trusts

Increasingly, retirement plan fee lawsuits allege that fiduciaries should have explored not only a cheaper mutual fund share class, but also a cheaper – but quite similar – version offered through a "collective investment trust" (CIT). A deeper exploration of CITs is beyond the scope of this White Paper, but the general overview in the following paragraph is intended to provide context for discussion later in the Paper.

The share class discussion above relates entirely to mutual funds, which fall under the purview of the Securities and Exchange Commission (SEC). CITs are maintained by banks and fall under the purview of the Office of Comptroller & Currency (OCC). For the longest time, CITs imposed significantly higher minimum investment requirements, which blocked CIT access for most plans. This has changed over time to the point that plans of all sizes have at least *some* access to CIT versions of some investment options. Although one can identify certain characteristics (other than expense ratio) that distinguish mutual funds from CITs, they are similar enough to allow for reasonable claims that fiduciaries should consider the availability of CITs when examining mutual fund share classes.

III. LEGAL AUTHORITY

Congress set out plan fiduciaries' responsibilities when it adopted ERISA in 1974. The Supreme Court's recent *Tibble* and *Hughes* opinions, issued in 2015 and 2022, respectively, confirm the application of those responsibilities to the retirement plan investment lineup and plan expense structures.

A. ERISA

ERISA's fiduciary duties are the "highest known to the law."[iv] ERISA imposes on fiduciaries a duty of prudence. A fiduciary must discharge his or her responsibilities with the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use.[v] ERISA also imposes on fiduciaries a duty of loyalty. A fiduciary must discharge its duties "solely in the interest of the participants and beneficiaries" and "for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan."[vi]

B. *Tibble v. Edison*

In *Tibble*, participants alleged that various plan-related fiduciaries acted imprudently by offering six higher-priced retails class mutual funds when "materially identical lower priced institutional mutual funds were available."[vii] On appeal to the Supreme Court, participants asked "how could [the fiduciaries] have acted prudently in offering the six higher priced retail-class mutual funds when [they] could have offered them effectively the same six mutual funds at the lower price offered to institutional investors like the Plan?"[viii] In essence, participants argued that there was no plausible argument that it was prudent to use a more expensive version of the same thing.

Yet *Tibble* was not really about whether those were "imprudent funds" or whether they were imprudently selected. *Tibble* considered whether the plaintiffs could advance fiduciary breach claims related to funds added to the plan before the statute of limitations period. The Court relied on trust law in holding that plan fiduciaries have both an initial responsibility to exercise prudence in selecting investments at the outset *and* a "continuing duty" to systematically consider all of the investments at regular intervals and remove imprudent ones.[ix]

The ultimate question, then, in *Tibble* was whether the participants had met their pleading burden or whether the trial court should have granted the fiduciaries' motion to dismiss the lawsuit. The Supreme Court did not attempt to answer that question; it remanded (sent back down) the case to the lower courts to reconsider the motion to dismiss with the "continuing duty" standard in mind. The trial court applied the Supreme Court's guidance and reversed its decision on the motion to dismiss. The continuation of the case opened the door to discovery and a trial that resulted in a multi-million dollar verdict for the participants and plaintiffs' attorneys.

C. *Hughes v. Northwestern University*

Northwestern University made available over 400 investment options to the participants of its two defined contribution plans. Participants filed a class action lawsuit alleging that the Northwestern fiduciaries breached their duty of prudence in a number of ways, three of which were at issue before the Supreme Court:

(1) The fiduciaries failed to monitor and control the fees they paid for recordkeeping, resulting in unreasonably high costs to plan participants;
(2) The fiduciaries offered retail share class funds with higher fees than those charged by otherwise identical institutional share class investments; and
(3) By offering too many investment options, the fiduciaries caused participant confusion and poor investment decisions.[x]

The trial court granted the fiduciaries' motion to dismiss. The Seventh Circuit Court of Appeals affirmed the dismissal. In doing so, the Seventh Circuit did not apply *Tibble*. Instead, it shifted its focus to a fiduciary's obligation to assemble a diverse menu of options. It reasoned that the fiduciaries had provided an adequate array of choices, including some low-cost index funds. In the Seventh Circuit's view, these offerings eliminated any claim that plan participants were forced to stomach an unappetizing menu. It further reasoned that because the participants' preferred type of investments were available, they could not complain about the flaws in other options. The court also dismissed claims relating to the recordkeeping expenses, reasoning that the amount of recordkeeping fees paid were within the participants' control because they had options to choose investment options with low expense ratios.

"That reasoning was flawed," the Supreme Court emphasized.[xi] It further emphasized that the Seventh Circuit erred in relying on the participants' ultimate choice over their investments to excuse allegedly imprudent decisions by the fiduciaries. In sending the case back to the Seventh Circuit, the Supreme Court essentially said: apply *Tibble*. In *Tibble*, the Court explained that even when participants may choose their investments, plan fiduciaries are required to conduct their own independent evaluation to determine which investments may be prudently included in the plan's menu of options. If the fiduciaries fail to remove an imprudent investment from the plan within a reasonable time, they breach their duty.

IV. SIGNFICANCE OF *HUGHES*: LOWER COURTS QUICK TO RELY ON IT

On its surface, *Hughes* is about procedure and not about "substantive" issues. The Supreme Court did not rule on the use of retail shares, reliance on revenue sharing, the active versus passive debate, or investment performance. It focused, instead, on two key procedural issues. The first – a clear reminder of the procedural nature of ERISA's fiduciary responsibilities – serves as encouraging reinforcement of strong fiduciaries' prudent process and attention to detail. The second – a reminder of the pleading standard for surviving a motion to dismiss – may serve as a wake-up call for fiduciaries that are not so careful.

The motion to dismiss stage is of critical importance. When plaintiffs' firms file retirement plan fee lawsuits, a primary goal is to get into discovery. The discovery process exposes organizations to headaches, legal expenses, and risk that other dirty laundry may see the light of day. Plan sponsors and fiduciaries file motions to dismiss in the hopes they can shut down a lawsuit early and without exposure to discovery. Defendants prefer for the courts to impose strict pleading standards; *Tibble* and *Hughes* are not great for defendants. Plaintiffs, on the other hand, prefer liberal pleading standards that allow their lawsuits to proceed so they might use discovery to strengthen their case and gain leverage for a verdict or settlement; *Tibble* and *Hughes* are helpful for plaintiffs. It did not take long for lower courts to demonstrate as much.

A. One Day Later: *Goodman v. Columbus Regional Healthcare System*

One Federal trial court in Georgia waited only one day to rely on *Hughes* in denying a motion to dismiss.[xii] The court had been awaiting the *Hughes* decision before ruling on the pending motion to dismiss in a case involving fiduciary breach claims relating to retail share class funds and excessive recordkeeping fees.[xiii] The court adopted a broad interpretation of *Hughes*, stating that "The Supreme Court has suggested that a defined contribution plan participant may state a claim for breach of ERISA's duty of prudence by alleging that the plan fiduciary offered higher priced retail-

class mutual funds instead of available identical lower priced institutional-class funds." Did the Supreme Court say that? No, it did not. Might courts interpret the Supreme Court as having suggested it? Yes, as we saw only one day after *Hughes* was released to the public.

The Georgia court also permitted the claim relating to excessive recordkeeping fees to proceed, recognizing that the participants had alleged that the recordkeeping expenses were nearly double what a reasonable recordkeeping fee would have been for a similarly sized ERISA plan.

B. A Matter of Minutes: *Lauderdale v. NFP Retirement*

A Federal trial court in California interpreted *Hughes* as articulating a two-level pleading standard for cases involving retail share class funds. It confirmed that "merely alleging that a Plan offers retail-class rather than institutional-class funds is insufficient to state a claim for the breach of duty of prudence.[xiv] To survive a motion to dismiss, the court asserted, there are two criteria that a plaintiff must satisfy: (1) an allegation that the lower-cost alternatives are "substantially identical"; and (2) some allegation of an imprudent process.[xv]

The participants were able to meet the first criterion by explicitly addressing the different available share classes and confirming they were substantially identical but for the expense structure.[xvi] They met the second criterion by presenting numerous specific allegations of an imprudent process, including alleging that meeting records indicated that the fiduciaries did not inquire about investing directly with the underlying managers, nor did they consider investing in the lower-cost shares.[xvii] This is particularly noteworthy: the participants supported their argument by highlighting that the fiduciaries' meeting minutes did not reflect a prudent process.

C. Believe It When We See It: *Salesforce.com* & *Trader Joe's*

The Ninth Circuit Court of Appeals also adopted an expansive view of *Tibble* and *Hughes* in reversing dismissals in a couple of cases. In *Davis v. Salesforce.com, Inc.*[xviii], the participants identified two lower-cost share class options (R5 and R6) for nine mutual funds offered by the plan. The court accepted those allegations as true and concluded that the allegations plausibly suggest that defendants acted imprudently by failing to switch to the lower-cost alternatives. It considered arguments relating to share classes and CITs:

- The fiduciaries argued that the R6 share class was less expensive only because it did not include any revenue sharing, which provided an obvious alternative explanation for why the fiduciaries previously used a more expensive share class and eventually switched to only the R5 share class. The court found that explanation to be "plausible". Yet it concluded that the defendants would need to wait until later in the lawsuit – perhaps in the summary judgment stage – to substantiate that argument.

- The fiduciaries also argued that there were good reasons for their failure to switch to CITs. The court concluded that whether there were good reasons for the delay in doing so "is itself a factual issue that cannot be resolved at the pleading stage."[xix]

Similarly, in *Kong v. Trader Joe's Company*[xx], the Seventh Circuit found dismissal to be inappropriate because the complaint plausibly alleged a failure to provide cost-effective investments due to the use of retail shares. The fiduciaries argued that there was a revenue sharing agreement that might provide some explanation for the choice of the more expensive share class, but the court

wasn't persuaded because "the agreement shows only what could occur in theory—not what occurred in fact."[xxi] In essence: we'll believe it when we see it, and we won't see it until later.

V. BEST PRACTICES

Hughes reinforces the prudent processes many plan fiduciaries had already implemented prior to *Tibble* or implemented following *Tibble*. For those plan fiduciaries, *Hughes* is much more validating than it is concerning. However, many plan fiduciaries have not yet adapted in response to *Tibble* and the other outcomes from around 15 years of steady retirement fee litigation. In either case, *Hughes* suggests that fiduciaries understand and implement each of the following practices.

A. Use the Cheapest Share Class

This is straight-forward: use the cheapest available share class. There are reasonable arguments for a couple of alternative approaches, but each has its flaws, so we suggest that fiduciaries keep it simple.

Some might suggest, for example, that fiduciaries use the "most efficient" share class so long as any revenue sharing would be credited directly back to each participant who invests in the fund that generates the revenue sharing. There are indeed instances when a more expensive share class might kick back enough revenue sharing to make up for – if not exceed – the difference in cost between available share classes. However, different approaches among various recordkeepers and imprecision within their various methods call into question the ability to consistently and accurately monitor when there is and is not efficiency. In addition, the *Salesforce* and *Trader Joe's* opinions reflect that some Federal courts would refuse to take into account the "most efficient" argument at the motion to dismiss stage.

Others might suggest that fiduciaries adopt a policy prohibiting any and all revenue sharing. That approach may add more transparency regarding plan expenses. In fact, it's an understandable – and perhaps the most conservative – approach. However, because categorically eliminating that entire universe of funds would dramatically narrow the list of otherwise-available investment options, it feels inconsistent with ERISA's duty of loyalty. The best practice is for the fiduciary to select the "best" investment option for an asset class, ensure the plan uses the cheapest version, and use any revenue sharing to reduce plan expenses. The courts have fairly consistently agreed that revenue sharing is not inherently prohibited or imprudent.

Of course, this issue would be easier if revenue sharing *were* prohibited or all revenue sharing were consistently proportionate across the various share classes. Until one of those developments occurs, the most straight-forward approach is to use the cheapest share class.

B. Consider CITs

Prudent fiduciaries will inquire regarding the availability of a CIT version of any selected option. The courts suggest that this inquiry should include two distinct questions: (1) is the plan eligible to use the CIT version? and (2) if the plan would not meet the minimum required for access to the CIT version, will the CIT trustee waive the minimum?

The second question was at issue before the *Tibble* trial court. The participants complained that the fiduciaries should have explored the use of CITs. The fiduciaries responded that the plans

would not have been eligible because they would not have met the minimum investment requirement. At trial, both sides' expert witnesses acknowledged that waivers are routinely granted when requested, which led many to consider *Tibble* to be the "duty to ask" case. Although waivers are less likely for smaller plans, it is nonetheless prudent to pose the question.

C. Use the Cheapest Share Class and Consider CITs for *Each* Investment

Hughes confirms that fiduciary responsibility applies separately to each investment option. This inherently requires that the share class and CIT assessments apply independently to each investment option. In the cryptocurrency context, the Department of Labor cited *Hughes* to support the conclusion that plan fiduciaries may not simply shift responsibility to participants to identify and avoid imprudent investment options.[xxii]

D. Document the Share Class and CIT Considerations

Meeting minutes should reflect the consideration of the appropriate share class and CITs. If a plan committee or other plan fiduciary has engaged an external fiduciary advisor under ERISA 3(21) or fiduciary investment manager under ERISA 3(38), it is wise to ask the external fiduciary to confirm, from time to time, that the plan is using the cheapest version of each investment option. The minutes should reflect that confirmation.

E. Know the Recordkeeper Fee

Recordkeepers use a variety of terms to describe the process for generating and receiving their fees. Some – particularly insurance company recordkeepers – may include their fees within an "asset charge" or "contract charge" that wraps around (adds to) the cost of an investment option. Others might only disclose the amount of revenue charged against participant accounts *after* the recordkeeper had collected revenue sharing. Consider the following examples:

(i) Plan A includes the following attributes: (a) a recordkeeping expense of 0.20%; (b) an advisor expense of 0.15%; and (c) revenue sharing equivalent to 0.02% of plan assets. Some recordkeepers would assess an "asset charge" of 0.33%, which reflects the result of 20 + 15 – 2.

(ii) The sponsor of Plan B pays the advisor's fees from company assets. Plan B includes the following attributes: (a) a recordkeeping expense of 0.20%; and (b) revenue sharing equivalent to 0.08% of plan assets. Some recordkeepers would assess an asset charge of 0.12%, which reflects the result of 20 – 8.

(iii) The sponsor of Plan C pays the advisor's fees from company assets. Plan C holds $10 million in plan assets and has the following attributes: (a) a recordkeeping expense of 0.20%; and (b) revenue sharing equivalent to 0.08% of plan assets. Despite receiving $20,000 in fees, some recordkeepers would disclose only $12,000 in fees, reflecting the amount charged after the recordkeeper pocketed $8,000 in revenue sharing.

In each of those examples, the recordkeeper's fee is the same. However, recordkeepers handle the communication of their fees in a variety of ways, including the three above. Thus, it is prudent to ask the recordkeeper to confirm its total revenue, which includes any revenue sharing amounts (which shouldn't be high if fiduciaries have implemented the best practices above) and any amounts charged against participant accounts.

F. Benchmark the Recordkeeper Fee

Ensure the recordkeeper fee is reasonable. It need not be the cheapest. But a consistent benchmarking process will likely have three effects: (1) triggering slight pricing reductions as the recordkeeper endeavors to stay in line with the market; (2) protecting fiduciaries against claims they did not know the recordkeeping costs; (3) protecting fiduciaries against claims they did not ensure those costs were reasonable; and (4) leading the recordkeeper to introduce new services that support the value afforded by its fee.

VI. CLOSING THOUGHTS

There are a large number of retirement fee lawsuits that reflect a sense of "20/20 hindsight". For example, they allege that fiduciaries breached their duty by failing to select a different fund that would have performed better than the option included in the plan lineup. These allegations frequently are not entirely dependent on procedure or supported by facts indicating imprudent processes. Instead, the plaintiffs' firms are merely second guessing.

This White Paper does not focus on those types of arguments; it focuses on reasonable "first guessing". The Department of Labor and Federal courts have provided many opportunities for fiduciaries to understand their approach on share classes and revenue sharing. In *Hughes*, the Supreme Court reminded us that it had made its position clear seven years before in *Tibble*. The above set of best practices will serve fiduciaries well, particularly as lower courts seek to avoid the nation's highest Court describing their reasoning as flawed.

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[i] *Hughes v. Northwestern Univ.*, 595 U.S. __ (2022), at *2.
[ii] *Id.*
[iii] *Tibble v. Edison Int'l*, 575 U.S. 523 (2015)
[iv] *Donovan v. Bierwirth*, 680 F.2d 263, 273 n.8 (2d Cir. 1982)
[v] 29 U.S.C. § 1104(a)(1)(B).
[vi] 29 U.S.C. § 1104(a)(1)(A).
[vii] *Tibble* at 526.
[viii] *Id.* at 526.
[ix] *Id.* at 526.
[x] *Hughes* at *3.
[xi] *Id*. At *2.
[xii] *Goodman v. Columbus Regional Healthcare System, Inc.*, Case No. 4:21-CV-15 (M.D. Ga. January 25, 2022).
[xiii] *Id.* at *1.
[xiv] *Lauderdale v. NFP Retirement, Inc.*, Case No. 8:21-cv-00301-JVS-KES (C.D. Cal. February 8, 2022) (quoting Kurtz v. Vail Corp., 511 F. Supp. 3d 1185, 1199 (D. Colo. 2021)).
[xv] *Id.* at *27.
[xvi] *Id.* at *28.
[xvii] *Id.*
[xviii] No. 21-15867, D.C. No. 3:20-cv-01753-MMC
[xix] *Davis* at *4-5.
[xx] No. 20-56415, D.C. No. 2:20-cv-05790-PA-JEM.
[xxi] *Kong* at *3.
[xxii] Compliance Assistance Release No. 2022-01 (March 10, 2022).

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