September 12, 2017

Attack on University Section 403(b) Retirement Plans – Litigation Update

Related Industries

Higher Education

Introduction

Over the past decade, private employers have been deluged with class action litigation under the Employee Retirement Income Security Act of 1974 (ERISA), which has challenged whether the administrative fees charged to participants' accounts in defined contribution retirement plans, such as their 401(k) plans, were excessive. Several of these cases have resulted in a number of large settlements – some greater than $50 million. About a year ago, the law firm responsible for many of the ERISA 401(k) excessive fee class actions – Schlichter, Bogard & Denton – turned its attention to the retirement plans offered by large universities. In a series of ERISA lawsuits filed last August, the plaintiffs alleged that the universities, as well as their retirement plan fiduciaries, breached their fiduciary duties owed to participants by failing to monitor their service providers and plan investments, and by failing to reduce the administrative fees charged to participants and beneficiaries.

While these new lawsuits resemble the 401(k) plan excessive fee cases against for-profit companies, they are also novel in that they focus on the universities' Section 403(b) retirement plans, which historically have not been a target of ERISA challenges. Notably, over the past year, several additional "copycat" suits have been filed against other universities by plaintiffs' attorneys other than the Schlichter firm. If any of these suits are successful, then retirement plans offered by a host of nonprofit entities – including hospitals and other educational institutions – may be ripe candidates for legal challenges as well.

Background of Section 403(b) Plans

A Section 403(b) plan is a tax-advantaged retirement savings plan available to public education organizations, some IRS Section 501(c)(3) nonprofit organizations, cooperative hospital service organizations and self-employed ministers in the United States. Essentially, Section 403(b) plans are much like 401(k) plans sponsored by private employers. Individual accounts in a Section 403(b) plan – also known as a tax-sheltered annuity (TSA) plan – can be an annuity contract provided through an insurance company, a custodial account invested in mutual funds, or a retirement income account set up for employees through either annuities or mutual funds. Contributions may be made through elective deferrals, non-elective deferrals from employer contributions and after-tax contributions. If the nonprofit employer offers an employer matching contribution or other non-elective contribution, then the plan must comply with ERISA and its regulations.

Section 403(b) Plan Complaints against Universities

Each of the complaints filed against the university defendants alleges fiduciary breaches that fall within at least nine categories:

- **Failure to Take Advantage of Plan Size to Reduce Fees and Costs –** The fiduciaries failed to take advantage of the plans' large size and economies of scale to determine if better and less expensive investment providers were available and to secure the best pricing for administrative and investment services.

- **Funds Invested In Are Too Expensive –** The fiduciaries failed to invest in alternative mutual funds that were available at lower costs and with similar risk characteristics.

- **Too Many Fund Options Available to Participants –** Participants were offered too many and duplicative investment options that charged higher fees and allegedly confused participants, preventing them from making educated investment choices.

- **Failure to Monitor Record-Keepers –** The plan fiduciaries should have monitored the record-keepers' decisions on investment options offered and failed to diligently investigate and monitor record-keeping costs and fees.

- **The Plan Retained Too Many Record-Keepers** – The plan fiduciaries should have consolidated plan investment management with a single record-keeper with which they could have negotiated more favorable fee terms.

- **Failure to Investigate Institutional Mutual Fund Investments –** The plan fiduciaries failed to investigate whether lower cost institutional mutual fund classes were available and instead retained higher cost retail classes.

- **Failure to Remove Underperforming Investment Options** – The plan fiduciaries breached their duty to monitor existing investment options by failing to remove options that exhibited poor performance against other available options and industry benchmarks.

- **Failure to Compare Overall Plan Fees Against a Participant-Based Fee –** The plan fiduciaries inappropriately continued to use investment options that included revenue-sharing arrangements instead of options with fees based upon a participant-based administrative fee.

- **Annuity Options Offered Were Too Expensive –** The plan fiduciaries retained "locked in" annuity investment options that imposed excessive administrative fees.

Generally, the university defendants moved to dismiss the original complaints, which then resulted in the filing of amended complaints that expanded the factual allegations related to the above theories. The university defendants then moved to dismiss the amended complaints, many of which remain pending before the courts. To date, only three district courts – the Middle District of North Carolina, the Northern District of Georgia and, most recently, the Southern District of New York – have ruled on the motions and dismissed some of the class claims against the universities. However, the bulk of the claims alleging that the fiduciaries breached their duties of prudence in monitoring or investigating investment options, administrative fees and costs have survived.

Recent Decisions on Motions to Dismiss

The first two district court decisions issued in May 2017 reached different results on some of the claims. The Northern District of Georgia dismissed the following fiduciary breach claims: (i) the claim that there were too many investment options available to participants; (ii) the claims related to the duty of prudence that sought damages occurring more than 6 years before the Complaint was filed because they were time-barred under ERISA's statute of limitations; and (iii) the claims that investment in mutual funds offered by a service provider involved a prohibited transaction. All other allegations and causes of action in the amended complaint identified above survived and are proceeding to discovery.

The Middle District of North Carolina also dismissed some of the claims in the plaintiffs' amended complaint, but did not follow the same logic as the Georgia district court. Specifically, the North Carolina court dismissed all allegations related to the imprudence of a "locked in" fee feature for certain annuity claims, finding that the claims were time-barred under ERISA's 6-year statute of limitations. The court also dismissed the fiduciary breach claim that the university did not properly monitor plan investments because the allegations were all conclusory. Also, like the Georgia court, the court dismissed the claims that investment in mutual funds offered by a service provider was a prohibited transaction. All of the other causes of action in the amended complaint identified above survived and will proceed to discovery.

On August 25, 2017, the Southern District of New York issued a decision in *Sacerdote v. New York University.* Shortly thereafter, on August 28, 2017, the same judge issued the latest decision in *Cates v. The Trustees of Columbia University in the City of N.Y.* The same judge presides over both the NYU and Columbia cases, and, like the Georgia and North Carolina courts, the judge did not dismiss the amended complaint in its entirety, but did dismiss several of the plaintiffs' fiduciary breach claims in each case. Because both amended complaints at issue were filed by the Schlichter firm, the motions to dismiss were also very similar. As a result, the court's opinion in the *Columbia* case expressly incorporates the majority of the earlier decision issued in the *New York University* case. Specifically, the court in each case dismissed the following claims:

- **Duty of loyalty claims were not supported by sufficient facts:** The plaintiffs alleged that the universities breached the duty of loyalty in three ways: (i) they favored the service providers' financial interests in bundling services; (ii) they allowed the service providers to offer their proprietary investments options without scrutinizing the revenue received by the providers; and (iii) they failed to consider the conflicts associated with offering the service providers' proprietary investments. The court found that the plaintiffs in both cases must allege plausible facts supporting an inference that the universities acted for the purpose of providing benefits to themselves or others. Here, plaintiffs offered only conclusory assertions that the universities each failed to act exclusively in the interests of participants and beneficiaries. Ultimately, the court concluded in both cases that mere allegations that the universities' conduct "advanced the financial interests” of the universities or the service providers would collapse the duties of loyalty and prudence into a single claim, and must be dismissed.

- **Duty of prudence claims that annuity options offered were too expensive dismissed:** Plaintiffs in both cases argued that the “lock in” arrangements breached the fiduciaries’ duties because they allegedly prevented the universities from independently assessing the prudence of each investment option or removing imprudent investments. The court disagreed, finding that the “lock in” feature did not demonstrate that the arrangement resulted in plainly risky investment options. Also, many of the available investment options in each case were not “locked in.” The court dismissed the claims because they were not based on facts, but only a belief that the investment options are risky or imprudent.

- **Claims that the Plans retained too many investment options dismissed:** Like the Georgia and North Carolina courts, the court also dismissed the plaintiffs’ claims in each case that there were too many investment options in the plans. In addition, the court found that the inclusion of retail investment options did not, on its own, suggest imprudence, as the low fees associated with the retail investments did not suggest an unwise choice by either university.

- **Plaintiffs’ prohibited transaction claims fail:** The court also dismissed the plaintiffs’ claims that permitting the service providers to use their own propriety investment options while also receiving fees from the plans suggested self-dealing or disloyal conduct. The court found that both amended complaints on this theory were supported only by conclusory allegations and prior case law did not support such a theory in either case.

- **Plaintiffs’ failure to monitor claims dismissed for lacking any allegations of misconduct:** The plaintiffs alleged that the universities breached their fiduciary duty of monitoring their delegated administrators, to the extent the universities delegated any of their duties to others. However, the plaintiffs claimed that since the universities are in exclusive possession of the information as to whether they delegated any fiduciary duties, the plaintiffs did not have specific allegations to support the claims. The court dismissed the claims, finding that the claims were merely a fishing expedition and not permitted.

After four court rulings on the motions to dismiss, a consensus of the types of claims that will likely survive the pleading stage has begun to surface. Each of these courts have permitted most of Plaintiff’s claims related to the duty of prudence to survive, including the claims that (i) the universities’ processes in selecting the service providers were flawed, (ii) the processes for monitoring the revenue sharing that existed for service providers were flawed, (iii) the processes for maintaining multiple service providers violates ERISA and (iv) the processes for continuing to offer investment options with high fees and poor performance breaches the fiduciaries’ duties.

<u>New Lawsuits Have Been Filed</u>

After the initial court filings about a year ago, in 2017, at least five new lawsuits have been filed against four universities and their Section 403(b) plans. In these new cases, law firms other than the Schlichter firm have filed the complaints, which raise claims very similar – if not mirroring – those in the older suits.

These new lawsuits will likely not be the last against colleges and universities and their Section 403(b) plans – in fact, if past is prologue, there will be many more plaintiffs' lawyers looking to get in on the action with respect to Section 403(b) plans.

Like private employers who often feared legal challenges to the administrative fees in their 401(k) plans, universities, as well as other nonprofit entities, must start considering their options related to their 403(b) plan investments and administrative fees. By assessing and making changes to their Section 403(b) plan governance rules and procedures now, universities might be able to avoid litigation and reduce their risk of liability.

Related People

Charles Stevens
Partner
cpstevens@michaelbest.com
T 414.225.8268