DEFINED CONTRIBUTION PLAN INVESTMENT LITIGATION

May 16, 2018

JCEB Advanced ERISA Litigation National Institute, Chicago Illinois

PRESENTERS:

Joanne Roskey, *U.S. Department of Labor,* Washington D.C.
Mary Bortscheller, *Cohen Milstein,* Washington D.C.
Robert Rachal, *Holifield · Janich · Rachal · Ferrera,* New Orleans, LA

Program Overview

– Prudence of investments in 401(k) and 403(b) plans
  - Performance against benchmarks
  - Composition and performance of target-date and QDIA funds
  - Prudence of alternative investments
  - Proprietary funds, prudence and loyalty claims

– Monitoring of investment and service provider fees

Prudence of Investments

Performance Against Benchmarks

Claims Based on Performance Against Benchmarks

- Courts will often find that allegations that a fund underperformed against benchmarks are insufficient, in themselves, to state a claim:
  - Noting that around half of funds will underperform benchmarks. *Sweda v. Univ of Penn.*, 2017 WL 4179572 (E.D. Pa. Sept. 21, 2017).
- But **additional** factual allegations may turn this into a plausible claim:
  - Persistent, long-term underperformance coupled with high fees.
    - Long-term underperformance will trigger monitoring obligations and claims.
    - High fees, when coupled with persistent underperformance, may raise inference of imprudence.
  - Allegations of self-dealing or conflicted interests for proprietary funds

Interesting Things to Watch

- New theory in *Birse v Century Link,* **challenging fund structure** in large-cap stock fund as imprudent and underperforming market:
  - Claiming have five different active managers with same investment mandate, means would cancel out and end up with index-like fund but with active management costs.

- If theory gains traction, could put at risk other actively managed funds with similar structures.
  - Closet indexing concern – prudence of paying active fees for what is for practical purposes an index fund.
  - Math – closet index fund will persistently underperform index by cost of extra fees for active management.

AMERICAN BAR ASSOCIATION

Prudence of Investments

Composition and Performance of Target-Date and QDIA funds

AMERICAN BAR ASSOCIATION

Background on QDIA and Target-Date Funds

- Qualified Default Investment Alternatives (“QDIAs) and target-date funds (which can be a QDIA) are often key investment options offered in a 401(k) or 403(b) plan.
  - They have risk – need for capital appreciation means typically have equity exposure.
  - Some were surprised by large losses in target-date funds (*e.g.*, 20% to 30%) in 2008 market crash.
  - Now target-date fund are much larger – Morningstar reports they have $880 billion in assets by end of 2016.

- Variances to common strategies, “glide-paths,” and benchmarks can create risk. If no variance though, why not be/use index target-date funds?

AMERICAN BAR ASSOCIATION

Recent Target Date Fund Claims

- *Jacobs v. Verizon Commc'ns., Inc.*, US Dist. Lexix 162703 (S.D.N.Y. Sept. 28, 2017). Claim that plan's target-date funds were overly risky based on their inclusion of several global equity and high-yield funds in their asset allocation.
  - Court dismissed claim: not *per se* imprudent to incorporate risky investments into a plan's investment menu.
  - Rather inclusion of a broad array of investments is in line with the U.S. Department of Labor's (DOL) requirement that plans "offer a broad range of investment alternatives that are diversified and have materially different risk and return characteristics."

Recent Target Date Fund Claims

- *Sulyma v. Intel Corp. Inv. Policy Comm.*, 2017 US Dist. Lexis 49788 (N.D. Cal. March 31, 2017). Challenging inclusion of hedge funds and private equity investments in target-date and diversified funds.
  - Participant filed his lawsuit more than three years after he elected these investments, claiming funds had performed unsatisfactorily because of an alleged over-allocation of funds to these alternative investments.
  - Court granted summary judgment, dismissing these claims as time-barred because the participant had ready access to detailed information on the allocation of funds to these investments. Participant could not avoid these disclosures by declining to access and read them.

AMERICAN BAR ASSOCIATION

Recent Target Date Fund Claims

- *Johnson v. Fujitsu*, 2017 US Dist. Lexis 73132 (N.D. Cal. April 11, 2017). Plaintiffs included challenges to investments in target-date funds, claiming they included too many unique and nontraditional asset classes, such as natural resources and real estate limited partnerships.
  - Court did not address this particular claim, instead allowing all claims to proceed as being "within the realm of plausible."
  - Other allegations included that this plan was most expensive "mega plan" in the country and that record keeping fees were 5 to 10 times more than for similar plans.

AMERICAN BAR ASSOCIATION

Alternative Investments on the Plan Menu

Key Developments 2017

AMERICAN BAR ASSOCIATION

Fiduciary Risk: Alternative Investments

- In 401(k) and 403(b) plans, plaintiffs have challenged target-date and other plan funds that contained a non-standard mix of investments that underperformed against market benchmarks.
  - Claims challenging investments in defined benefit plans have faced issue of whether plaintiffs have standing/injury-in-fact if plan is well funded.

- Courts generally rejecting these claims on 401(k) and 403(b) plans when (i) fund's investment strategy was disclosed, and (ii) participants had opportunity to invest in other more plain-vanilla investments. *Jacobs v. Verizon, Sulyma v. Intel.*
  - *But see Johnson v. Fujitsu* where court did not address the claim, but allowed it to go forward because other allegations that plan paid excessive fees showed imprudent conduct.

Fiduciary Risk: Alternative Investments

- *In re Disney ERISA Litig.*, 2017 US Dist. Lexis 61202 (C.D. Cal. April 21, 2017). Rejected challenges to Sequoia fund's concentrated investment in pharmaceutical company Valeant.
  - Plan offered a diversified mix of investment options, and Sequoia fund's concentrated strategy and its risks were disclosed to participants.
  - Also rejected amended claim that Sequoia fund should have been a value fund – nothing prefers value over growth investments, and fund's disclosures were consistent with its investment strategy.

Proprietary Funds:

Prudence and Loyalty Claims

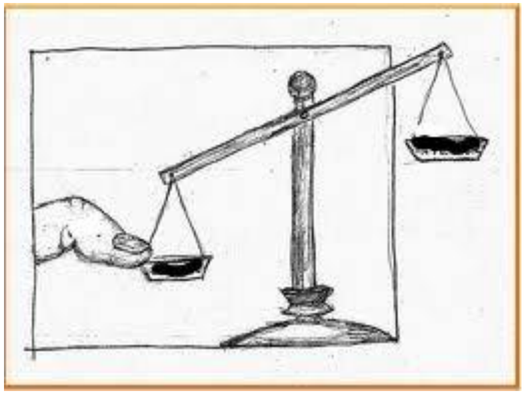
Proprietary Fund Litigation

- DC plan litigation in the proprietary fund context yielded several decisions in 2017.
  - Proprietary fund cases = plan is offering funds in which employer or affiliated company has an interest, *e.g.*, Putman funds in the Putman 401(k) plan.

AMERICAN BAR ASSOCIATION

Proprietary Fund Litigation

- Plaintiffs generally defeated motions to dismiss if they could allege some fact consistent with fiduciaries acting in the employer/fund provider's interest, *e.g.*:
  - limiting menu options to proprietary funds.
  - having higher cost proprietary index funds.
  - using plan investments to seed new proprietary funds.



Proprietary Fund Cases

- To survive a motion to dismiss, courts have found it is not sufficient to plead only:
  - that cheaper alternative funds were available; and
  - that menu options in the Plan underperformed the market.
- “Something more” required

AMERICAN BAR ASSOCIATION

Proprietary Fund Cases: MTD Denied

- *Schapker v. Waddell & Reed Financial, Inc*., 2018 WL 1033277 (D. Kan. 2018).
- "Plaintiff alleges more than simply that Defendants failed to select the cheapest or highest-performing funds to include in the Plan."
  - All options on Plan menu resulted in fees paid to Waddell & Reed or an affiliate; only one unaffiliated investment option ever offered on the menu.
  - And, excessive fees, poor performance

AMERICAN BAR ASSOCIATION

Proprietary Fund Cases: MTD Denied

- *Schapker v. Waddell & Reed Financial, Inc*., 2018 WL 1033277 (D. Kan. 2018).
- “Taken together, these circumstantial facts give rise to a plausible claim that Defendants' process in selecting the Plan’s funds was flawed, and that Defendants breached their duties of prudence and loyalty to the Plan participants.”

Proprietary Fund Cases: MTD Denied

- *Cryer v. Franklin Templeton Resources, Inc*., 2017 WL 818788 (N.D. Cal. Jan. 17, 2017).
  - 40 mutual funds on 401(k) plan menu were managed by Franklin Templeton or subsidiaries
  - Plaintiff alleged they charged excessive fees and underperformed relative to comparable alternatives.
  - Allegations of self-interested conduct.
    - MTD denied. Class certified July 2017

Proprietary Fund Cases: MTD Denied

- *Wildman v. American Century Services, LLC*, 237 F.Supp.3d 902 (W.D. Mo. 2017).
  - 401(k) Plan investment options were all proprietary funds; Plaintiffs alleged that the funds were excessively expensive.
    - MTD denied Feb. 2017. Class certified Dec. 2017.

Proprietary Fund Cases: MTD Granted

- *Meiners v. Wells Fargo & Co*, 2017 WL 2303968 (D. Minn. May 25, 2017).
  - Proprietary TDFs were default investment option; Plaintiff alleged WF seeded funds.
  - Comparison to Vanguard, Fidelity funds rejected: different investment strategies, different costs.
  - District court not persuaded by allegations that Defendants acted in self-interest when selecting proprietary funds.
  - On appeal to Eighth Circuit

Proprietary Fund Cases: Trial

- Defendants also won at trial in *Brotherston v. Putman Inv.*, 2017 U.S. Dist. Lexis 93654 (D. Mass. June 19, 2017):
  - Through class period, all of the investment options on the Plan's investment menu were affiliated with Putnam.
    - But no breach of duty of loyalty to offer own funds in 401(k) plan when Putman (i) made more than $40 million in discretionary contributions to the plan, and (ii) paid for recordkeeping services.
  - On duty of prudence claims, court rejected “procedural breach” theory of damages because it improperly assumed that all investments were imprudent.
  - On appeal to the First Circuit.

AMERICAN BAR ASSOCIATION

Proof of Causation: Breach and Damages

Key Developments 2017

Proof of Causation Breach and Damages

- *Tatum v. RJR Pension Inv. Comm.*, 855 F.3d 553 (4^{th} Cir. 2017), addressed "substantive" prudence, whether defendant can avoid liability for breach of procedural prudence by showing a prudent fiduciary "would have" made the same decision.
  - Procedural breach was selling off "cookie" stock after spun off Nabisco from tobacco company. After sold, cookie stock took off. No prudent process in deciding to sell, seems that some thought had to sell once spun off company.

Proof of Causation Breach and Damages

- *Tatum v. RJR Pension Inv. Comm* (cont.):
  - Earlier, Fourth Circuit held fiduciary had to show a prudent one "would have" sold stock, not that they could have.
  - On remand, district court found "would have" standard was met. Fourth Circuit agreed. Fund had inherent risk of single-stock fund plus risk of tobacco taint from risk if RJR went bankrupt, and no reason to expect extraordinary returns since market for this stock was efficient.
  - Dissent: Plan required keep Nabisco fund as a frozen fund. Not factor this in for what a prudent fiduciary "would have" done, thus need another remand.

Monitoring Investment and Service Provider Fees

General Developments

- Claims challenging low-cost funds because allegedly could have offered cheaper share classes or funds have had mixed results: Defendants won in *White v. Chevron* but claims are proceeding in *Bell v. Anthem*.
- On claims challenging inclusion of retail versus institutional share class, courts are looking at (i) whether actually had ready access to institutional share class, and (ii) whether extra fees paid on retail shares were reimbursed to the plan under revenue sharing.

General Developments

- On recordkeeping fees claims, claims against university 403(b) plans that they paid too much for recordkeeping through revenue sharing or by having multiple recordkeepers have generally moved forward. *E.g., Sacerdote v. NYU*.
- Courts have generally allowed recordkeeping fee claims to go forward if plaintiffs can allege fees are excessive in relation to comparable benchmarks. *See Johnson v. Fujitsu* (claiming fees were 5 to 10 times more than benchmarks).
  - But see *White v Chevron* (allegations showing that as plan grew in size plan fiduciaries moved to a per-participant charge undercut plausible inference of imprudence)

ABB: Exposure on Recordkeeping Fees

- *Tussey v ABB, Inc.*, 2012 WL 1113291 (W.D. Mo. Mar. 31, 2012). Court rejected multiple claims against plan and record keeper Fidelity. But found fiduciaries breached duties by paying record keeper too much in fees.
  - Record keeper paid revenue sharing based on percentage of assets invested in those funds; court found plan did not monitor total fees paid, even after expert said record keeper likely was overpaid.
  - Plan's overpayment may have been subsidizing work Fidelity did for non-qualified plans.
- Plaintiff's win on this one claim was worth $13.4 million in liability, plus attorney's fees to date of $11 million (case is ongoing).
- Do NOT have to go with lowest cost provider, but need to monitor and document why paying fees.

DOL Enforcement and Amicus

- *Tussey v ABB, Inc.* (8th Cir. 2013)
- *Tatum v. RJ Reynolds Tobacco Co.* (4th Cir 2013)
- *Tatum v. RJR Pension Investment Comm.* (S. Ct. 2015, 4th Cir. 2016)
- *McCaffree Financial Corp. v. Principal Life Ins. Co.* (8th Cir. 2015)
- *Acosta v. Wedbush Secuirites, Inc.* (C.D. Cal. 2017)