The Business of ERISA Excessive Fee Litigation is Booming

"As for those who might contemplate future service as plan fiduciaries, all I can say is: Good luck." – Circuit Judge J. Harvie Wilkinson, Tatum v. RJR Pension Inv. Committee (4th Cir. 2014)

Since 2013, the volume of ERISA class action lawsuits against 401(k) plan fiduciaries has risen dramatically. In particular, cases alleging “excessive fees” have blossomed into the main driver of the increase. Nearly 100 new cases claiming breaches of fiduciary duty in connection with plan fees were initiated in 2020.

SUMMARY

- Excessive fee claims have been included in the majority of 401(k) lawsuits since 2014, but the number of fee suits exploded in 2020
- New law firms, not previously known as ERISA specialists, are entering the arena and contributing to the growth of claims
- Once mainly a concern for large 401(k) plan sponsors, small and mid-sized 401(k) plans and 403(b) plans are now being targeted
- Sound fiduciary structure and process may not prevent a lawsuit but may be a sponsor’s best bet to escape a costly trial, settlement, or judgment

BACKGROUND

In excessive fee claims, a participant (current or former) and their counsel allege that a plan is paying too much to a service provider (most commonly its recordkeeper) or investment manager(s). Excessive fee claims involve two basic expectations of fiduciaries under ERISA: 1) that fiduciaries follow a prudent process to ensure that a plan pays only reasonable fees for necessary services; and 2) that fiduciaries act “with the care, skill, prudence, and diligence” of a “prudent expert” when selecting investment options. In excessive fee suits, plaintiffs allege a breach of one, the other, or both.

The first wave of ERISA excessive fee class action lawsuits came in late 2006, when the law firm Schlichter, Bogard, and Denton initiated virtually identical lawsuits against several very large companies in multiple federal courts. Until 2014, excessive fee claims took a back seat to cases focusing on “inappropriate investment choices” (in part due to the roiled markets of the Financial Crisis of 2007-2008.) In the years since, however, allegations of excessive fees have dominated defined contribution litigation. In 2020, plaintiffs launched more than 100 class action lawsuits connected to 401(k) plan fees. (Read “401(k) litigation and the root of fiduciary risk” for a better visual on the claims in 401(k) class action suits.)

When confronted with an excessive fee lawsuit, plan fiduciaries may move to dismiss the suit by arguing that the claims presented, even if true, don’t constitute a breach of fiduciary duty. The general strategy of plaintiffs’ firms is to survive the motion to dismiss, then try to encourage a settlement by subjecting the defendant to an expensive discovery process. The costs involved can be a strong incentive for a sponsor to settle. Even an ultimately successful defense can be an extremely expensive exercise for plan sponsors, amounting to hundreds of thousands or even millions of dollars.

TRENDS

Aside from the trend of growth in the number of excessive fee suits, what's changed?

Smaller plans and non-401(k)s are being targeted: Historically, excessive fee class actions generally targeted large plans, usually with well over $1 billion in assets. The first targets included giants like Lockheed Martin, Boeing, Caterpillar, and International Paper. However, in recent years, suits have increasingly targeted small and mid-sized plans, including those with less than $100 million in assets and fewer than 1,000 participants. Prime examples include Checksmart Financial LLC ($25 million plan) and LaMettry's Collision (a $9 million plan).

Excessive fee litigation has also expanded from 401(k)s to other types of plans, most notably 403(b)s. Since 2016, multiple universities and health systems have faced fee suits, including Northwestern (dismissed), Brown University (settled for $3.5 million), and MIT (settled for $18.1 million).

New firms are getting involved: Though a handful of firms still dominate the actions, law firms that weren't previously recognized as ERISA specialists have begun to file excessive fee claims. Materials created by the first wave of excessive fee cases, including complaints, pleadings, and legal research, have paved the way for new entrants to shape their arguments. In addition, the proliferation of database tools containing information from public filings such as Form 5500s has eased access to data for smaller law firms, reducing an impediment that had previously advantaged plan sponsors. In short, the availability of information has reduced the cost of entry into the excessive fee "industry," and the field is expanding.

Lawsuits are replicating: Coincident with the entry of new legal firms into the space have been accusations of "cookie-cutter" lawsuits, where firms use identical arguments, often based simply on publicly available 5500 information, to file multiple suits. ERISA defense law firm Morgan, Lewis, and Bockius made this charge in one motion to dismiss, claiming that the plaintiff counsel's allegations were essentially identical to those in a previous case "right down to the typos."

COVID-19!?!?: A somewhat unexpected addition to the list of impacts of the pandemic, anecdotal evidence suggests that COVID restrictions might share the blame for the spike in excessive fee suits in 2020. In the first three months of 2020, plaintiffs filed roughly four excessive fee suits per month. After three months of work-from-home and COVID restrictions, the rate spiked to more than a dozen suits filed each month in June, July, and August. This may well be correlation rather than causation, but the theory is that participants and retirees had a lot more time on their hands, making it easier for plaintiff-side law firms to find people willing to talk. That's more important than it might seem: as Groom Law Group wrote in 2020, "In fact, the primary hurdle to bringing an excessive fee claim may be the ability of the plaintiffs' bar to recruit a plan participant to serve as a named plaintiff."

WHERE THINGS COULD BE HEADED

Excessive fee suits will become even more common: As informational barriers to entry into the excessive fee industry continue to drop, more firms will enter the space. As with most maturing industries, new players will have lower costs and will accept smaller margins.

Small and mid-sized plans will be more frequent targets: Plaintiff's firms that target smaller plans may not have the opportunity for a dramatic multi-billion-dollar plan payday, but they'll have many more targets from which to choose. Unfortunately, they may also have an easier time demonstrating a fiduciary breach by a less-prepared sponsor or forcing a settlement from a plan with fewer resources with which to mount an expensive defense.

Other costs, such as consulting fees, will become the subject of excessive fee suits: Consultants' fees haven't drawn the same scrutiny as recordkeeping or investment fees. This may be partly because, in large plans, the dollars involved tend to be relatively small compared to overall plan assets. However, consulting fees often represent a more significant portion of plan assets in small and mid-sized plans and may draw greater attention from plaintiffs' firms.

WHAT MIGHT MAKE A PLAN A TARGET

Based on past litigation, there appear to be particular characteristics that may make a plan more likely to be targeted with an excessive fee lawsuit. Note that we're not making any broad judgments regarding any of these factors; we're simply presenting what appear to be risk factors.

- Recordkeeping
    - Accepting quoted recordkeeping rates without bargaining for lower fees
    - Paying recordkeeping fees that are structured as a percentage of assets rather than as a fixed, per participant rate
    - Not moving to a fixed, per participant rate as plan assets grow
    - Not regularly issuing periodic Requests for Proposals (RFPs) from recordkeepers

- Plan Investments
    - Using a recordkeeper's proprietary funds, especially target-date funds
    - Using investment options that pay revenue sharing to a plan's recordkeeper
    - Not using the lowest-cost mutual fund share class available
    - Not using the lowest-cost vehicle available (mutual fund, collective trust, or separate account)
    - Not offering index funds or not offering "enough" index funds
    - Retaining funds that have underperformed relative to benchmarks

Again, we're not making any judgments about, for example, using a recordkeeper's proprietary target-date funds. Depending on the situation, that choice could be prudent (and, hopefully, the rationale for use would be well-documented). The characteristics listed above are simply common complaints in excessive fee claims.

OUR PERSPECTIVE

Prepare for a lawsuit: Given the current environment, plan sponsors may be justified for feeling that an excessive fee suit is more of a question of "when" rather than "if." However, by preparing to defend against an excessive fee case, sponsors may wind up reducing their lawsuit risk profile. Aside from essential "people, policy, and process" fiduciary structuring, there are specific steps that sponsors can take that may prepare for or protect against an excessive fee suit:

- Recordkeeping
    - Periodically benchmark the costs and services of recordkeeping and managed account providers using appropriate, independent benchmarks
    - Adopt a regular schedule for soliciting formal recordkeeping bids (e.g., issue an RFP once every three years)
    - Don't simply accept quoted fees: negotiate where possible
    - Determine if the recordkeeper is receiving revenue from investments or managed account services and understand how this impacts the plan's costs

- Plan Investments
    - Conduct regularly scheduled meetings to monitor your plan and its investments
    - Compare investment performance to appropriate peer groups and benchmarks
    - Benchmark investment expenses to appropriate institutional peer groups (not just retail averages)
    - Be aware of all share class and vehicle options available to your plan
    - Carefully consider investment costs in your investment selection; fees are the only “known knowns” in investing

Position for a dismissal: Careful documentation is critical. Costs associated with lawsuits jump exponentially once they move to the discovery phase. Documentation of a prudent fiduciary process, including the proper preparation of committee members, compliance with prudent policies, and the rationale for fiduciary decisions, may make the difference between a dismissal and a trial or settlement.

Purchase fiduciary insurance: Fiduciaries are personally liable for breaches of fiduciary duty, putting every plan fiduciary’s personal assets at potential risk (and the plan itself can’t indemnify them). This is true even where employers have hired a 3(38) discretionary plan advisor or participate in a pooled employer plan. Those steps don’t eliminate liability; they simply change the fiduciary’s responsibilities.

Given that exposure, it’s good practice for plan fiduciaries, regardless of plan size, to hold fiduciary liability insurance policies from a reputable carrier. Though fiduciary insurance costs have risen as the pace of ERISA litigation has increased, many employees may justifiably consider it a prerequisite to committee participation. (On a personal note, if you’re on an investment committee and you don’t know if you’re covered by a fiduciary insurance policy, you may want to look into that.)

Consider a Fee Policy Statement: Just as an investment policy statement sets forth a formal policy for selecting and monitoring plan investments, a fee policy statement memorializes a strategy for handling plan fees. It can detail which expenses are to be paid by the plan sponsor, which are to be paid by the plan participants, and how participant fees are to be allocated (pro rata, per capita, or to individuals). It may also formalize policies for handling revenue sharing. A properly-composed fee policy statement can demonstrate regular, prudent fiduciary processes and serve as a convenient reference and source of documentation.

IN CONCLUSION

Excessive fee suits will likely continue to proliferate. Once mainly a concern of large plan sponsors, small and mid-sized plans can expect to be more frequent targets of fee claims. Sound fiduciary structure and process may not prevent a lawsuit but may be a sponsor’s best bet to escape a costly trial, settlement, or judgment.

Contact Jay Young (jay.young@vergencepartners.com) or me (tom.douglas@vergencepartners.com) with any comments or questions. Visit www.vergencepartners.com and follow us on LinkedIn to see what else we’re thinking about.

FOR INSTITUTIONAL USE ONLY

Vergence Institutional Partners LLC is registered as an investment adviser with MA, MI, RI, and TN. Vergence Institutional Partners LLC only transacts business in states where it is properly registered or is excluded or exempted from registration requirements.

This report is a publication of Vergence Institutional Partners LLC. Information presented is believed to be factual and up to date, but we do not guarantee its accuracy, and it should not be regarded as a complete analysis of the subjects discussed. All expressions of opinion reflect the judgment of the author as of the date of publication and are subject to change.

Information contained herein does not involve the rendering of personalized investment advice but is limited to the dissemination of general information. A professional adviser should be consulted before implementing any of the strategies or options presented.

Information is not an offer to buy or sell, or a solicitation of any offer to buy or sell the securities mentioned herein.

Past performance may not be indicative of future results. Therefore, no current or prospective client should assume that the future performance of any specific investment, investment strategy (including the investments or investment strategies recommended by the adviser), or product made reference to directly or indirectly, will be profitable or equal to past performance levels.

All investment strategies have the potential for profit or loss. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will either be suitable or profitable for a client's investment portfolio.

Historical performance results for investment indexes or categories generally do not reflect the deduction of transaction and custodial charges or the deduction of an investment-management fee, the incurrence of which would have the effect of decreasing historical performance results. You cannot invest directly in an index.

Economic factors, market conditions, and investment strategies will affect the performance of any portfolio, and there are no assurances that it will match or outperform any particular benchmark.

Vergence Institutional Partners LLC does not provide legal advice. The information herein is general and educational in nature and should not be considered legal advice.

20210331TLDTLD0024