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After Supreme Court Ruling, Are TDFs A Ticking Time Bomb Of Fiduciary Liability?

by Christopher Carosa, CTFA January 25https://fiduciarynews.com/2022/01/after-supreme-court-ruling-are-tdfs-a-ticking-time-bomb-of-fiduciary-liability/

On Monday, January 24, 2022, the United States Supreme Court unanimously overruled the Seventh Circuit's decision to dismiss the case of Hughes et al v. Northwestern University et al. This highly anticipated ruling by the nation's highest court held that "The Seventh Circuit erred in relying on the participants' ultimate choice over their investments to excuse allegedly imprudent decisions by respondents. Determining whether petitioners state plausible claims against plan fiduciaries for violations of ERISA's duty of prudence requires a context-specific inquiry of the fiduciaries' continuing duty to monitor investments and to remove imprudent ones as articulated in Tibble v. Edison Int'l, 575 U. S. 523."

The specific case of Hughes deals with Northwestern's alleged: "(1) failing to monitor and control recordkeeping fees, resulting in unreasonably high costs to plan participants; (2) offering mutual funds and annuities in the form of 'retail' share classes that carried higher fees than those charged by otherwise identical share classes of the same investments; and (3) offering options that were likely to confuse investors."

The Supreme Court did not rule on the viability of Hughes claim nor on whether the case should be heard. It just stated that the Seventh Circuit cannot dismiss the case in the manner which it did. The Seventh Circuit must now reconsider whether to dismiss the case. It may still rule to dismiss, but for other reasons.

Despite the nature of the Hughes case, the wording in the Supreme Court decision may have an impact on how other 401k cases are treated.

“Since the pleading standard for breaches of fiduciary duty are context-specific, as the Supreme Court unanimously determined, it will be more difficult to have such claims dismissed at the motion to dismiss stage, says Marcia Wagner of The Wagner Law Group in Boston, Massachusetts.”

By a striking coincidence, two stories appeared last week that, together with the Supreme Court ruling, might cause 401k plan sponsors to grow concerned about the Target Date Funds (TDFs) now consuming so much of their plans’ assets.

The first story involves a class-action lawsuit brought against Milliman Inc. for its decision to use in-house funds with no track record as its 401k plans sole target risk options. These funds underperformed the market.

The second article, by TDF expert Ron Surz, poses that, in choosing what he calls “the Big 3” TDF provides, plan sponsors may be taking a “$3 trillion gamble they are about to regret.”

“Most fiduciaries believe that procedural prudence limits their choice to the Big 3 TDF providers—Vanguard, Fidelity, and T Rowe Price,” writes Surz. “Fiduciaries want protection from lawsuits, so they choose the most popular TDFs… The conflict of interest exists when popular TDFs do not serve the interests of participants and expose them to significant risk in that Risk Zone.”

Surz believes TDFs may be overweighted in equities. (For what it’s worth, other researchers, on the other hand, have the opposite opinion and believe TDFs are too cautious.) If you recall what happened during the 2007/2009 stock market crash, many TDF significantly underperformed their expectations and Congress was called to investigate.

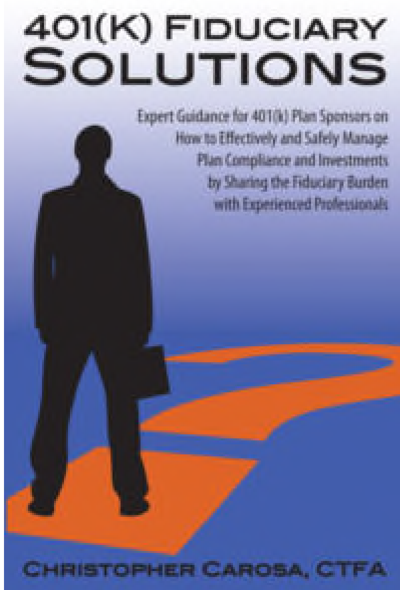
Nothing much happened then, but this time may be different.

“Fiduciaries may be of the mistaken impression that they have little liability with respect to TDFs because they fit the QDIA bill for DOL and ERISA purposes. However, prudent and educated fiduciaries are aware that TDFs are probably the greatest source of exposure in their plans,” says Matthew Eickman, National Retirement Practice Leader at Qualified Plan Advisors in Overland Park, Kansas.

Eickman says there are three reasons why this might be the case: “First, the growing prevalence of automatic enrollment has resulted in a higher percentage of retirement plan monies being invested pursuant to a default election. Second, the application of automatic enrollment and default investment elections increased when the pandemic triggered more virtual and less hands-on employee onboarding processes. Third, when a plaintiffs’ firm determines its interest in a potential lawsuit, it’s looking for chunks of money. The DOL’s Form 5500 filing system (EFAST2) makes it all too easy for plaintiffs’ firms to identify plans with a large amount invested in TDFs. Pair that with reporting software and middling-at-best performance of many TDF suites, and TDF-related fiduciary risk is higher now than it’s ever been.”

When assessing the potential for fiduciary liability, one can divide the risks into two categories: conflicts-of-interest and failure of process. In neither case is poor performance itself seen as a stand-alone risk, but it often precipitates an action in one of these two categories.

“Breach of fiduciary duty claims based upon the selection of proprietary product present different legal issues than standards regarding breach of the duty of prudence in the selection and monitoring of non-proprietary funds that have poor performance,” says Wagner. “With respect to the former, concepts of prohibited transactions and conflicts of interest arise, in addition to issues concerning claims for breach of the fiduciary duties of appropriate and reasonable monitoring and selecting. With respect to claims of breach of fiduciary duty resulting from poor performance of non-proprietary products, the issue is whether the selection and monitoring processes were reasonable and prudent. The case law is clear that a court’s focus is on process, not outcome.



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"There are circumstances where plaintiffs' attorneys might be more likely to file lawsuits if the investments 'underperform,'" says Fred Reish of Faegre Drinker in Los Angeles, California. "One is where the TDF uses investments that are not 'vanilla;' think of Intel and hedge funds in the TDF. They won the suit, but sometimes a victory in a lawsuit still feels bad. Another is the conflict-of-interest issue that you mentioned. Of course, an expensive share class is a problem where a less expensive one is available to the plan. And another is substantial underperformance to the 'average' TDF."

The conflicts-of-interest inherent in selecting proprietary funds are apparent. Less so are the criteria used to determine what a suitable process might be.

"The parameters of the duty to monitor are not well defined, and a claimant may allege that the process was inadequate," says Wagner. "So, regarding TDFs, it will be important for the plan fiduciary to have an adequate understanding of the manner in which the TDF operated, beyond asking basic questions such as whether the TDFs were 'through' or 'to' constructions, and was there adequate benchmarking."

Most plan sponsors rely on their service providers to both define the process and maintain the process. Still, it is the 401k plan sponsor that has the ultimate responsibility that this process be faithfully and continually executed.

"Plan fiduciaries aren't legally obligated to select the best performing funds or the cheapest funds," says Mitch Shames, the founder of Harrison Fiduciary in New York City. "They are required to act in the best interest of the

plan participants. This includes establishing and following a prudent process for making all plan decisions, implementing that process, and documenting it every step of the way. Once selected, a rigorous process for ongoing monitoring of TDF's should be established. That fiduciary process should include, among other things, monitoring the TDF's performance relative to a benchmark and to its peers. Documenting not only all decisions made, but the reasons behind those decisions, is essential. It's important to remember a fiduciary's responsibility goes beyond assessing performance."

So, what does this all mean in light of the Supreme Court ruling? Yes, there may be more scrutiny in all cases, but the practical impact may be less than anticipated.

"A number of courts suspended activity in ERISA breach of fiduciary cases, awaiting guidance from the Supreme Court on pleading standards at the motion to dismiss stage," says Wagner. "A number of cases are dismissed at least in part at the motion to dismiss stage for reasons that won't be affected by today's decision. The Supreme Court decision is broadly speaking pro-participant, but District Courts may have been hoping for more detailed guidance with respect to pleading standards."

Remember, for all the headlines the filing of cases receive, the end result is usually less dramatic.

"The big picture, though," says Reish, "I don't think there is much chance of a lawsuit against an established TDF suite where the expenses are reasonable and the performance is more or less in line with the performance of the other major TDF families."

Christopher Carosa is an award-winning online news producer and journalist. A dynamic speaker, he's the author of 401(k) Fiduciary Solutions, Hey! What's My Number? How to Improve the Odds You Will Retire in Comfort, From Cradle to Retirement: The Child IRA, *and several other books on innovative retirement solutions, practical business tips, and the history of the wonderful Western New York region. Follow him on* Twitter, Facebook, *and* LinkedIn.

Mr. Carosa is available for keynote speaking engagements, especially in venues located in the Northeast, MidAtlantic, and Midwestern regions of the United States and in the Toronto region of Canada.

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