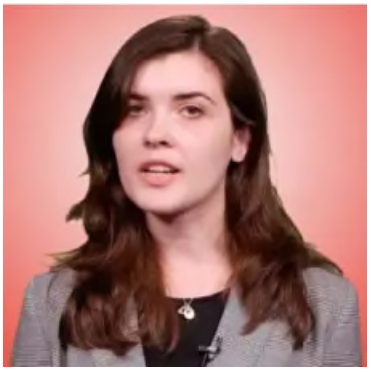
Making lemonade of legal lemons, new wave of ERISA class actions accuse fiduciaries of 'imprudently' using low-fee, high-rated funds, like BlackRock TDFs

The lawsuits against 401(k) plan sponsors also threaten every RIA and fiduciary, if underperformance becomes a legal liability, lawyers say.

Wednesday, September 21, 2022 – 9:34 PM by Oisin Breen



Megan Pacholok: If the lawsuits are successful, this [could] lead plan sponsors facing similar questions on every fund offered.

Retirement plan sponsors are fake fiduciaries if they offer cheap, highly rated funds from premium brands in 401(k) plans without factoring in fund performance, according to a fresh wave of ERISA class action cases.

Most of the 11 outstanding class actions allege that plan sponsors chose BlackRock LifePath target-date-funds (TDF) as their default 401(k) option simply because they had the superficial markings of a fiduciary process rather than engaging in an authentic one.

Now plan sponsors had best pay attention to the claims and climb to higher tree branches if called for, according to Ari Sonneberg, partner

at Wagner Law Group, via email.

Max Schatzow: 'Have a prudent process.'

"Plan sponsors would be well-advised to avoid being the proverbial low-hanging fruit," says the attorney at the Boston ERISA and employment law specialist.

"Underperformance, combined with a lack of well-contemplated investment selection processes, or the failure to adhere to documented processes, most certainly can be the basis of a successful suit," Sonneberg says.

It's warning that RIAs should also heed lest they expose their flanks even as they shore up old vulnerabilities -- like choosing more expensive share classes.

Fiduciaries at risk

The class actions, mostly filed (91%) by the Philadelphia law firm Miller Shah, allege that plan sponsors failed as fiduciaries. See: Fidelity Investments reveals 'all-time high' 401(k) plan sponsor discontent, thanks to DOL monkey wrench that creates 'race to bottom,' key expert adds

They "imprudently" "chased low fees" over performance, when higher fee funds often outperformed what it labels as the "deplorable performance" relative to their peers of the BlackRock TDF, according to one Miller Shah filing.

Miller Shah failed to respond to three requests for comment, but it has already successfully sued plan sponsors that use Fidelity Freedom Funds– Fidelity's actively managed TDFs -- by default, alleging imprudent investment choices and excessive fees.

"[But] if Miller Shah is allowed to profit by alleging that plan fiduciaries committed malpractice by selecting the highly rated, low-cost BlackRock TDFs, then every fiduciary in America is at risk of being accused of malpractice," says Daniel Aronowitz, principal and attorney at Euclid Fiduciary in Vienna, Va.

"In other words, if the BlackRock TDFs can be challenged, then every investment selection can be," he says in comments provided to Plan Adviser.

BlackRock TDFs outperformed roughly 73% of its peers over three- and five-year time periods, according to Morningstar Data.

Chiseling an opening

The 2020 Department of Labor (DOL) fiduciary rule has also opened the door to canny litigants.

Since the fiduciary rule became law more than two years ago, lawyers have successfully litigated a number of 401(k) class actions. Some 58% of all 401(k) plans invest in TDFs, according to Morningstar Data.

Of 170 401(k)-linked suits filed since December 2020, the courts dismissed roughly 12, and plaintiffs settled at least 19 for more than $68 million, according to Bloomberg Law research.

Miller Shah, for instance, recently settled its case against the Coca-Cola Consolidated 401(k) plan over its use of Fidelity Freedom Fund TDFs.

As a result, fiduciaries who merely tick the low cost and independently rated boxes when choosing a plan provider leave themselves open to tricky lawsuits, according to Sonneberg. See: Morningstar jumpstarts its star rating system with favorable self-review yet audit finds it misses the mark in bear markets.

Daniel Aronowitz: It's a brazen claim of fiduciary imprudence.

“Plan participants, even in plans with the ‘best’ investment options, will experience investment losses. But the easier targets for litigators looking to capitalize … [are] sponsors that aren't diligent when it comes to their fiduciary responsibilities in selecting an investment option menu,” he explains.

Brazen claim

Easy-target TDFs aside, the legal theory used by Miller Shah is illogical, says Aronowitz.

“Taken to its logical conclusion, they're [arguing] the entire $280 billion invested in BlackRock TDFs represent[s] imprudent investment choices," he told Plan Adviser.

“It's a brazen claim of fiduciary imprudence … that you owe [potentially] hundreds of millions of dollars if you don’t deliver top performance in the market." See: DOL monkey wrench creates 'race to bottom,' key expert says.

The rating, standing and fees of its TDFs are sufficient to stand up to legal challenge, according to BlackRock.

Bill Singer: [They're] challenging Wall Street's long-voiced mantra.

"BlackRock is widely recognized as a market leader in TDFs, with a deep commitment to retirement investing research and a long history of engagement with defined contribution plan sponsors and their consultants," says a company spokeswoman, via email.

"Our investment process takes into account multiple factors, including return objectives, market cycles, time horizon and risk management.

"As a result, BlackRock's LifePath Index funds are highly regarded by many fiduciary decision-makers and independent evaluators of investment products for delivering consistently strong outcomes for plan participants over time."

Liability trap

BlackRock stands on solid ground, says Sonneberg.

"It's hard to say with a straight face that a case alleging a breach of fiduciary duty in connection with the inclusion of a highly rated BlackRock TDF in an investment lineup has merit," he argues.

"[It's] ambulance chasing …" adds Aronowitz, via email.

"If you can allege malpractice for choosing the highest-rated funds, then you can sue on any investment. ERISA was not designed to be a liability trap, but that is what the lawsuits want to create."

Today, an estimated $3.27 trillion is managed through TDFs, which initially favor riskier equity heavy portfolios then slowly increase their position in fixed income assets as an investor ages.

BlackRock is the fourth largest TDF manager in terms of the value of assets under its management, with $289 billion, according to Morningstar Data.

Sleep walking

Yet Miller Shah wouldn't sue unless plan sponsors exposed themselves to claims of malpractice, adds Bill Singer, attorney and writer of the Broke and Broker blog, via email.

"It's a question of whether the fiduciary has, in fact, oversold me on their 'services,' when, as I learn, they simply relied upon a rating agency, looked at the cheapest fund and put me and virtually all others similarly situated into that [fund].

"As the lawsuits allege, we have far too many folks sleepwalking," he adds.

What lawyers like Aronowitz fail to acknowledge is that buying good, cheap groceries, and providing a good meal are two different notions, Singer continues.

“It's certainly debatable whether a fiduciary obligation is discharged simply because … I hired you as a chef, you went to Whole Foods, bought store brands, and I ate what you bought without getting sick,” he argues.

“What effort did the fiduciaries expend other than merely ‘selecting the highly rated, low-cost BlackRock TDFs’?

"It's not that the investments necessarily went to zero and investors were killed by the funds. It's a question of what due diligence was done.

Ari Sonneberg: 'Avoid being the proverbial low-hanging fruit.'

Pristine world

“[The] pristine world of rating agencies [isn't] so conflict-free [either], and let's not forget the recent multi-million fine on Morningstar by the SEC … for 'violating a conflict of interest rule,'” Singer adds.

In May 2020, Morningstar paid a $3.5 million settlement to the SEC in a suit addressing its separation of its credit ratings and analysis from its sales and marketing efforts.

“Perhaps the absurdity of the TDF lawsuits is that a court will say that plans should better explain to investors that the funds aren't really doing all that much hard work,” Singer concludes.

Damned each way

Morningstar issued its own response to recent TDF-linked lawsuits, including Miller Shah's, in a Sept. 7 article penned by manager research analyst Megan Pacholok, titled "New 401(k) Lawsuits Go Too Far."

Pacholok writes that plan sponsors are damned if they do and damned if they don't, because now that litigation against high-fee funds has pushed plan sponsors to favor lower cost TDFs, lawyers are targeting low-fee funds that perform worse than high-fee funds.

Some $62 billion of net inflows went into low-fee TDFs in 2022; whereas plan sponsors withdrew $38 billion from higher fee funds, according to Morningstar's 2022 Target Date Landscape report.

“The lawsuits' primary focus on past returns versus a hand-picked group of peers could set a dangerous precedent,” says Pacholok.

"If plan sponsors have to worry that they will face a lawsuit for periods when a series isn't a top performer, it can potentially lead them to performance-chasing and swapping out TDFs more often than they should.

"If the lawsuits are successful, this [could] lead plan sponsors facing similar questions on every fund offered in their 401(k) lineups," she adds.

High stakes game

Yet the idea that Miller Shah's suits are without merit, or that any success would undermine the 401(k) industry is simply legal grandstanding, counters Singer.

“Given the high stakes for which these TDF lawsuits are playing, I expect that both sides of the cases will resort to hyperbole," he argues.

“No question that many of these TDF lawsuits seem spurious … [but they're] challenging Wall Street's long-voiced mantra that you give us your money and we will work hard to invest it … saying that this is only a hollow promise.”

Sanctions and consolidation

Aronowitz also argues that the courts should consolidate all Miller Shah's outstanding suits into one case, and that the company should face court sanction for making "objectively unreasonable claims."

“The cases should be consolidated to prevent one law firm from getting many bites at the apple for the same basic claim … All of the cases are based on circumstantial evidence, and … [they] raise the same issue … fiduciary imprudence for alleged underperformance," he says, via email.

“When you accuse a product like Roundup of causing cancer, courts consolidate the cases into multidistrict litigation to prevent the same issue from being litigated to different results. This is the risk in the BlackRock imprudence claims,” he adds.

Both Singer and Aronowitz agree that a consolidated case is unlikely, owing to the involvement of multiple jurisdictions, and the fact that each case addresses a different firm’s investment "process."

The U.S. District Court for the District of Colorado has already imposed sanctions on one firm currently pursuing a case involving BlackRock TDFs, namely Schlichter Bogard & Denton of St. Louis, Mo.

Schlichter Bogard & Denton just agreed – along with Emeryville, Calif., fellow litigant Wallace Cottrell Konecky – to pay $1.5 million in sanctions for “recklessly” prosecuting an excessive fee case.

“If anything good comes out of frivolous ERISA fiduciary breach suits, perhaps it will be an increase in the incidences of such sanctions," says Sonneberg.

"When even the prudent decisions of plan fiduciaries can be called into question and lead to costly litigation, that cannot be good for [plan] participants,” he adds.

Safe Harbor

The Miller Shah suits should not, however, keep any firm involved in administering 401(k) plans up at night, as long as they cross their ‘T’s and dot their 'I's, says Max Schatzow, co-founder of RIA Lawyers, via email.

“If fiduciaries have a prudent process ... and the TDFs are objectively a decent selection, then they would seem to be free from liability.”

Sonneberg says "any valid case … [has] to show that the selection of the investment in question illustrates a failure of plan fiduciaries to minimize the risk of large losses and a failure to act with the care, skill, prudence, and diligence … [any] prudent person … familiar with such matters would have used.

“Many times [it] come[s] down to showing there was a formal process followed by fiduciaries to choose plan investments, and whether or not that process was sound.

"Underperformance of an investment choice cannot, per se, be a valid basis for a breach of fiduciary case under ERISA,” he explains.

RIABiz obtained the quotes attributed to Miller Shah in this article from the company's Aug. 19 suit against the fiduciaries administering the $865 million CUNA Mutual 401(k) Plan. Lawyers have labeled the Miller Shah suits as effectively identical.

Vanguard Group is the largest domestic TDF vendor, with $1.2 trillion under its management, followed by Fidelity ($460 billion), and T.Rowe Price ($374 billion).

FAA

September 22, 2022 — 8:04 AM

IMO- the real risk for 'fiduciaries' is not being able to follow/document and defend the decision making process. There is zero evidence to suggest anyone can consistently select out performing investment strategies prospectively...the Alpha Fairy comes and goes, if it exists at all. The other point, as related to TDF's misses the mark- the majority of returns (look at any academic research) comes from asset allocation and not from underlying

investment choices. There's plenty of room to take action against the sponsor/advisor but what they have laid out doesn't make a lot of sense.

Brian Murphy

September 22, 2022 — 1:51 PM

Laughable, if it wasn't so sad. DOL needs to do a better job of defining "prudent investing" for the benefit of all sponsors, but again they write regulations/guidance of their own that leave far too much room for interpretation. We're on a slippery slope that leads to nowhere. I would also say that there should be some penalty for "class action" lawsuits brought that don't have merit in the judges eyes.

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Fidelity Investments reveals 'all-time high' 401(k) plan sponsor discontent, thanks to DOL monkey wrench that creates 'race to bottom,' key expert adds

Some 47% of plan sponsors are considering a new advisor, up from 34% last year, and 48% are considering a change of recordkeepers.

Monday, September 12, 2022 – 9:51 PM by Lisa Shidler

0 Comments

Louis Harvey: You could say the DOL is at the root of the problem.

> ***Brooke's Note: Remember the DOL Rule and all the hubbub around it? We had half-forgotten about it, too. The Trump Department of Labor (DOL) took a scalpel to the original Obama administration version in 2020, but it still had a few rose bush thorns of its own. We all turned our attention to COVID, and now Fidelity is taking stock with a study. It found that a record number -- about half -- of all plan sponsors expressed displeasure with the companies that keep and advise on their 401(k) assets. Is it a coincidence that 'record-high' restlessness follows on the heels of legislation written to make 401(k) service providers do a better job? At least one tip-top expert says you can draw a reasonably straight line between cause and effect.***

The DOL rule may finally be turning the 401(k) industry upside down -- with help from market conditions -- based on the head-spinning results of the latest Fidelity Investments plan sponsor survey.

The survey revealed that competition among plan advisors and recordkeepers "is reaching an all-time high." It puts nearly $5 trillion of defined contribution assets in play or near to it.

Some 47% of plan sponsors are considering a new advisor, up from 34% last year, and 48%

are considering a change of recordkeepers, the Fidelity survey found.

Aaron Schumm: 'The shift in market dynamics starts to create greater scrutiny.'

Louis Harvey, president of Dalbar Inc., a Boston market research company, says Department of Labor (DOL) rules emphasizing low fees have caused many 401(k) lawsuits and may be one of the reasons driving change. See: The DOL's Trump-era reprieve from rollover fiduciary rigor is over with aspects of remedy that might 'scare the daylights' out of defense lawyers

“The DOL has done virtually no enforcement, but it is their regulatory disclosures 408(b)(2) and 404(a)(5) that have enabled the excessive fee lawsuits. So, yes, you could say the DOL is at the root of the problem," Harvey says by email.

"The rules caused fee disclosure so the plaintiffs had the information to file lawsuits. 408(b)(2) required fee disclosures to plan sponsors and 404(a)(5) required fee disclosures to participants. Before they went into effect, it was extremely difficult to obtain the information needed to sue." he said.

He adds that the myopic focus on cutting fees is causing a "race to the bottom."

Litigation frenzy

The Trump administration released an exemption-happy rule, which emphasized lower fees over quality service. The rule was approved and adopted in December 2020, though plan sponsors' takeaway remained roughly the same as the 2017 version. See: The DOL's Trump-era reprieve from rollover fiduciary rigor is over with aspects of remedy that might 'scare the daylights' out of defense lawyers

An explosion of litigation over 401(k) plan fees followed. Plaintiff's lawyers filed more than 170 class actions leading to tens of millions of dollars in settlements, according to a Bloomberg Law analysis.

Scott Smith: 'It's no longer good enough to get a plan established.'

The suits are essentially based on "cookie cutter" allegations that employers are mismanaging retirement plans by offering expensive investments and failing to curb administrative fees.

“For more than five years, plan sponsors have been surrendering to allegations that record keepers are undifferentiated except for fees. Eventually, plan sponsors are beginning to believe this falsehood and therefore actively seek lower cost replacements,” Harvey says.

“The unfortunate aspect is this trend creates a ‘race to the bottom,’ which hurts only the participants since recordkeepers are forced to degrade their service to remain viable,” he says.

The U.S. Supreme Court gave litigators a more precise running lane in January by reviving a lawsuit by Northwestern University employees challenging the school's retirement plan fees and investment lineup.

Employees argued that a plan has to do more than offer an array of investment options -- some good, some not so good. Retirement plans must offer only the most prudent fund options at the lowest cost.

Not surprisingly, 51% of plan sponsors say they want more advisor expertise in many areas, notably proactive suggestions for improving plan performance, according to the Fidelity survey.

Dynamic shift

Poor service is extra degrading during the perfect storm of inflation and bad markets waking plan sponsors to broader 401(k) service issues, says Aaron Schumm, CEO of Vestwell, a startup digital recordkeeper.

Vestwell has about $25 billion in assets with 25,000 employers as clients and 1 million participants.

Liz Pathe: 'Plan sponsors are continuously seeking more expertise.'

"The shift in market dynamics starts to create greater scrutiny on 401(k) plan structures, bringing into question aspects that would've taken a backseat from consideration before," Schumm says.

When these shifts happen, Schumm says a small firm like his reaps the rewards. "All of these factors, amongst others, work to our favor at Vestwell."

Fidelity's survey of 1,285 plan sponsors with at least 25 participants and $3 million in plan assets, found that the high concerns focus on the way 401(k) fiduciaries choose to invest.

Some 93% of those surveyed said they plan to make changes to their investment menu lineup and 88% want a change in plan design.

The Fido survey particularly indicts recordkeepers and advisors for poor employee communications and education. Recordkeepers were also cited for being ineffective in dealing with service issues, during the 2020 pandemic, according to the study.

Advisor impact

Oddly, the study showed that 76% of plans were satisfied with their advisors -- the highest level in five years -- even though 47% of employers said they are looking for a new advisor and recordkeeper.

Scott Smith, an analyst at Cerulli Associates in Boston, attributed the anomaly to plan sponsors who are likely content, but not necessarily impressed, by the advisors they are working with.

"This signals an increase in the baseline competency levels for advisors in the space. It's no longer good enough to get a plan established and working smoothly.

"The advisors need to be able to show how they are impacting the biggest areas of interest for sponsors: employee communications, investment lineup, and service issues."

Liz Pathe, head of defined contribution investment-only sales at Fidelity Institutional, agreed, saying plan sponsors want experts.

"Plan sponsors are continuously seeking more expertise from their plan advisors year-over-year to help them in a more diversified capacity and are not afraid to look elsewhere if a competing advisor offers a better experience," she said in a statement.

Cerulli analyst Shawn O' Brien says only about 19% of plan sponsors are actively seeking a new recordkeeper, according to Cerulli data.

Net benefits

"The biggest surprise is the severe effect litigation has already had on plan sponsors," Harvey says.

"On the other hand, plan sponsors are also awakening to two factors that compromise the participant retirement security.

"First is the need for support at and after retirement, and the second is the massive loss of returns due to pointless asset allocation.

The 60/40 asset allocation is applicable to less than 5% of participants but is routinely used for more than 95% of cases."

In keeping with that observation, 93% of sponsors said they plan to make changes in their investment lineups.

Expanding sustainable environmental, social and governance funds, increasing other investments and managed account options drew about equal support.

Harvey is sure Fidelity sees the study signifying greener pastures more than red flags.

“As for the effect on Fidelity, there is a net benefit for them," he says. "Being among the top recordkeepers in the business, they are most likely to win far more business than they lose when changes take place.”

Louis Harvey | Aaron Schumm

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