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Is Investment Performance a Fiduciary Duty?

ERISA attorneys review what the law and a decade or more of case law require of plan sponsors.

Reported by ED MCCARTHY | *Art by* CLAUDI KESSELS

Plaintiffs filed two lawsuits in January that focused on their retirement plans' investment offerings.

First, participants in Southwest Airlines' 401(k) plan filed a class action complaint alleging the airline failed to remove the Harbor Capital Appreciation Fund, a large-cap growth investment option, from the plan lineup, despite a history of underperformance over 15 years. By December 31, 2018, the fund had lagged behind its benchmark, the Russell 1000 Growth Index, and other funds in the same category over the preceding three, five and nine years.

The complaint contends that the failure to replace the Harbor fund was a breach of fiduciary duty that caused significant financial losses for plan participants, as compared with what they would have earned in similar, better-performing funds. The Harbor fund's cumulative under-performance from 2010 through year-end 2018 ranged from -10.02% against the benchmark to -37.60% against the category's top performer.

Also in January, former employees of Trader Joe's filed a complaint claiming that approximately 70% of the plan's assets—nearly $2 billion—were invested in the American Funds American Balanced Fund R4 until 2021, despite the availability of a lower-cost collective investment trust alternative. The plaintiffs argued that this overconcentration in a single fund with higher fees and the alleged mismanagement of forfeited funds breached the company's fiduciary duties under ERISA.

The Trader Joe's plan had more than 44,000 participants and $2.7 billion in assets under management at the end of its 2023 plan year. The plan's recordkeeper, Capital Group, charged each participant $48 annually for its services; the plaintiffs maintain that a plan of that size should have negotiated a lower per-participant fee.

Available Guidance

But did the sponsors of the plans violate their fiduciary responsibilities? According to Marcia Wagner, founder and managing partner of the Wagner Law Group, there is no fiduciary duty under ERISA to maximize investment return for plan participants and beneficiaries.

"As the [U.S.] 8th Circuit [Court of Appeal] indicated in *Meiners v. Wells Fargo*, there is no authority requiring a plan fiduciary to pick the best-performing fund," she explains.

Wagner notes that the Department of Labor describes the duty of prudence under ERISA at a principle-based high level that considers "the risk of loss and the opportunity for gain (or other return) associated with the investment compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks."

"There is no question that the relevant plan fiduciary should engage in benchmarking and the peer review of investments, and at some point in time remove an underperforming fund, but there are no explicit required rules in this regard," says Wagner.

As Wagner explains, regulators have not established hard rules on when plan investment offerings need to be replaced. If a plan has an investment policy statement, that document should provide guidelines for retaining or removing underperforming funds. However, she adds that there is no right or wrong solution when making these decisions.

ERISA's general standard of fiduciary prudence is vague by design, says Rick Pearl, a partner in the Faegre Drinker law firm.

"ERISA was not meant to micromanage," Pearl explains. "It was meant to say to fiduciaries, 'If you are not an expert on an issue and you have to make a decision about an issue that requires some expertise, you act like a prudent person would in that situation, consistent with how trustees act in state law trusts, and you go out and you seek expert advice.'"

Pearl points to Section 404(c) of ERISA as providing guidance on structuring investment menus. The section's provisions and DOL regulations shield plan fiduciaries from liability for participants' investment decisions, as long as the fiduciary provides sufficient choice, information and control over investment options. A significant requirement is that that plan offers a menu of investment options that span the risk-reward spectrum. However, fiduciaries must still ensure the overall prudence of the plan's investment offerings.

Courts Weigh In

Court cases also provide some guidance. Wagner cites *Meiners v. Wells Fargo* and *Patterson v. Morgan Stanley* as two cases highlighting the role of comparative fund performance in determining a breach of fiduciary duty due to a fund's underperformance.

Several other legal cases are relevant to the current lawsuits. In *Tibble v. Edison* in 2015, the plaintiffs alleged that the plan administrators' decision to include retail-class mutual funds, instead of lower-cost institutional funds, was a breach of fiduciary duty. The suit focused on whether plan fiduciaries were required to continually monitor their plan's investment options and remove imprudent choices. The U.S. Supreme Court ruled unanimously in favor of the plaintiffs and emphasized the need for an ongoing review of a plan's investment and costs.

Hughes v. Northwestern University in 2022 reinforced the Tibble decision. Participants alleged that the university's 403(b) plan confused participants by offering too many investment options. They also cited the plan's use of higher-cost funds when lower-cost alternatives were available, as well as excessive recordkeeper fees resulting from the plan's failure to consolidate service providers.

The Supreme Court found in favor of the plaintiffs, citing a lower court's failure to apply the *Tibble* precedent properly. The Supreme Court also emphasized that fiduciaries must continuously monitor investment options and remove imprudent choices, even if other prudent options exist within the plan.

A fiduciary does have an obligation to be conversant in the characteristics of an investment option that might affect the goals of the investment, says Pearl: "So, although the plan fiduciaries don't have to be experts, if there are fees or other considerations that are affecting the fund or the investment option that they have, then it is the obligation of the fiduciary to understand those considerations and ask questions of their expert advisers."

The Importance of Process

Wagner explains that fulfilling the duty of prudence requires focusing on the process used to select, retain and replace plan investments. In her experience, though, process and investment results are not always related. A plan fiduciary with a deficient process for evaluating investments might, simply by luck, achieve favorable investment performance, while a rigorous and disciplined process might not produce favorable investment results.

"But prudence, because it is not measured in hindsight, does not look to results," she says. "The prudence of a plan fiduciary's activity is based upon the manner in which he or she evaluated and acted upon the information that was available when the decision to retain or remove was made."

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Reported by Ed McCarthy