LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

When 403(b) Prudence Claims Survive Dismissal

By **Arthur Marrapese** (May 16, 2018, 2:26 PM EDT)

Arthur Marrapese

In March of this year, the U.S. District Court for the District of Connecticut in Vellali v. Yale University granted in part and denied in part a motion to dismiss a lawsuit against Yale's 403(b) plan fiduciaries. The Vellali complaint alleges that Yale's 403(b) plan sustained losses resulting from the mismanagement of the plan's investment and record-keeping functions.

The decision in Vellali follows similar rulings by Second Circuit district courts in connection with motions by 403(b) plan sponsors in substantially similar suits brought by the same class action law firm: Cunningham v. Cornell University,[1] Sacerdote v. New York University,[2] and Cates v. Columbia University.[3] District court Judge Kathleen Forrest authored the opinions in Sacerdote and Cates.

The Vellali complaint alleges that the plan's fiduciaries violated three core Employee Retirement Income Security Act standards: The duty of loyalty, the duty of prudence and the duty to avoid engaging in (or causing the plan to engage in) a prohibited transaction. This article summarizes the ruling in Vellali, compares it to the rulings in Cunningham, Sacerdote and Cates, and concludes with a few prognostications on the future of these kinds of claims in the Second Circuit.

This article does not discuss the prohibited transaction claims in any detail, which were dismissed in Cunningham, Sacerdote and Cates, but not dismissed in Vellali.

The "Lock-In" Claim — The Loyalty Claim Fails, The Prudence Claim Survives

The complaint accuses the Yale fiduciaries of violating ERISA's duties of loyalty and prudence by selecting and maintaining "bundled" 403(b) investment platforms sponsored by TIAA-CREF and Vanguard. The complaint alleges that, under the terms of the plan's contract with TIAA, Yale could not offer TIAA's flagship product — the TIAA Traditional Annuity — without using TIAA's allegedly unreasonably expensive record-keeping services and without offering certain allegedly imprudent TIAA investments.

According to the plaintiffs, Yale fiduciaries breached their duty of loyalty to the participants by allowing the plan's investment and record-keeping vendors to enrich themselves through a steady stream of proprietary investment and record-keeping revenue. The Vellali court, like the courts in Cunningham, Sacerdote and Cates, dismissed the duty of loyalty claim, ruling that the plaintiffs had failed to plausibly

allege that the fiduciaries adopted and maintained the arrangement for the principle purpose of benefiting a party other than the participants (e.g., themselves or TIAA).

The decision to select and maintain TIAA's bundled program allegedly violated the duty of prudence because it prevented the fiduciaries from removing imprudent investments (i.e., "unbundling" plan investments), and locked the plan into retaining TIAA as a record-keeper regardless of the cost-effectiveness and quality of its services. In an apparent shot across the "bundled" plan bow, the court held that the complaint plausibly alleged facts suggesting that the fiduciaries had contractually "abdicated their responsibility to monitor and remove imprudent investments and reduce exorbitant fees" even though the complaint did not allege that Yale was contractually precluded from terminating the entire arrangement on reasonably short notice. The court in Cunningham dismissed a virtually identical prudence claim on the grounds that it is not per se imprudent for a plan to adopt and maintain a "bundled" 403(b) platform. In so ruling, the court suggested that a bundled arrangement that could not be terminated on reasonably short notice might be viewed differently. In addition, the courts in Cunningham, Sacerdote and Cates observed that the allegedly imprudent investments represented a small fraction of the plan's available investment options, and that the plaintiffs had not alleged that participants were required to invest in any particular option.

Excessive Record-Keeping Fees — Prudence Claims Survive

The complaint alleged that Yale fiduciaries "grossly" overpaid for record-keeping services because they failed to take the steps a prudent fiduciary would have taken under the circumstances. The complaint estimated that the plan paid between $200 and $300 per participant per year, an amount well in excess of the alleged market rate of $35 per participant per year for plans of the same size (roughly 15,000 participants).

According to the plaintiffs, a prudent fiduciary would have

- Determined the market for services by soliciting bids from competing record-keeping providers;
- Leveraged the plan's size to negotiate lower fees;
- Determined and monitored the amount of revenue sharing, compared that amount to the going rate for comparable plans, and rebated any excess amounts to the plan; and
- Consolidated from two record-keepers to one.

According to the plaintiffs, the Yale fiduciaries failed to take these steps.

In ruling that the plaintiffs had plausibly alleged that record-keeping expenses were unreasonably high, the court rejected Yale's argument that the court should adopt the standard used by courts under Section 36 of the Investment Company Act of 1940; namely, that a fee is excessive only where the service provider charges a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered, and could not have been the product of arm's length bargaining. The Cunningham, Sacerdote and Cates plaintiffs were equally successful in avoiding dismissal of essentially identical prudence claims.

Underperforming Funds — Prudence Claims Survive

The plaintiffs alleged that the defendants imprudently retained numerous investment options that

underperformed relative to their benchmarks. Not surprisingly, the Vellali, Cunningham, Sacerdote and Cates courts, like virtually all other courts facing similar claims, agreed these claims should survive. The court in Sacerdote cited Second Circuit precedent for the proposition that to state a prudence claim connected to the retention of certain investment options, a plaintiff must raise a plausible inference "that a superior alternative investment was readily apparent such that an adequate investigation would have uncovered that alternative."

Excessive Number of Investment Options — Prudence Claim Dismissed

The plaintiffs claimed that a prudent fiduciary would have consolidated the plan's allegedly excessive number of investment options — over 100 — into a "core lineup." The complaint alleges that offering too many investment options causes decision paralysis, high costs and dilution of bargaining power, and impairs a fiduciary's ability to adequately evaluate all plan investment options. In dismissing this claim, the court ruled that the plaintiffs did not adequately allege that too many investment options actually caused any harm to the plan or its participants. The ruling in Vellali is consistent with the prior rulings in Cunningham, Sacerdote and Cate.

Failure to Replace Retail Funds with Institutional Funds — Prudence Claim Not Dismissed

The Vellali complaint alleged that the Yale fiduciaries breached their fiduciary duty of prudence by offering specific retail mutual funds as investment options over lower cost, but otherwise identical, institutional funds. The court held that the complaint plausibly alleged a prudence claim because it alleged a failure to evaluate the prudence of specific plan investments. In contrast, the court in Sacerdote and Cates dismissed an identical claim citing to Second, Third, Seventh and Ninth Circuit case law for the proposition that when retail funds are just several of a wide range of options, and where the fees associated with those retail funds fall within ranges permitted by other courts, their inclusion is not imprudent. The ruling in Vellali is consistent with the prior ruling in Cunningham. In Cunningham the court distinguished the Third, Seventh and Ninth Circuit precedent relied on in Sacerdote and Cates, noting that the courts in the cited cases considered challenges to the overall range of investment options offered by the plans, rather than the prudence of particular investment options.

Unduly Expensive Variable Annuities — Dismissed

The complaint alleged that the CREF variable annuities charged distribution fees for marketing services and fees relating to mortality and expense risks that were of little or no value to the plan participants. With respect to the TIAA real estate account, the plaintiffs alleged that in addition to the above, the real estate account charged a "liquidity" guarantee that is not charged by comparable funds. The court dismissed these claims on the grounds that the plaintiffs did not allege that these fees could have been lowered through negotiation, or that the plan could have offered a comparable product with lower fees. The ruling in Vellali is consistent with prior rulings in Cunningham, Sacerdote and Cates.

Prognostications

Bundled Arrangements or Open Architecture?

With the possible exception of the court in Vellali, it does not appear that courts are willing to conclude that 403(b) platforms that bundle proprietary investment products with record-keeping services are per se imprudent. ERISA does require that these programs be prudently selected and monitored; therefore, if an imbedded investment becomes imprudent, the responsible fiduciaries would be duty bound to

remove the imprudent investment or, if that is not possible, terminate the arrangement altogether. Where the plan's fiduciaries cannot unilaterally remove an imprudent investment option such as, for example, where an annuity contract is issued to the participant instead of the plan, the fiduciaries should consider developing participant disclosure materials specific to the investment option at issue.

Retail Funds or Institutional Funds?

The inclusion of retail funds as plan investment options is not per se imprudent. However, if a complaint alleges that a fiduciary selected a specific retail fund over a lower cost, but otherwise identical institutional share class, the claim will likely survive, especially if defects in process are also alleged. As the Vellali court observed, fiduciaries can defend these kinds of claims by offering legitimate reasons for selecting a particular retail fund over an identical institutional fund (e.g., where the additional costs are used to offset administrative and record-keeping costs). It remains to be seen whether the mix and range of investment options in a plan will be relevant in determining the prudence of including retail funds in a plan's investment lineup when identical institutional funds are available. The court in Sacerdote appears to have answered this question in the affirmative, while acknowledging that the Second Circuit has not addressed the precise question.

Too Many Investment Options?

It seems relatively clear that it is not per se imprudent to offer substantially more than a "core" group of investment options. To state a prudence claim under these circumstances, it appears that a complaint will need to plausibly allege that specific participants were actually harmed, that costs were actually greater than they should have been (e.g., because of duplication and lost leverage), or that the fiduciaries actually failed to monitor and remove specific imprudent investment (which is an independent duty) as a consequence of having too many funds to monitor. Interestingly, the court in Cunningham suggested that an investment fiduciary of a plan with an expansive number of investment options might be able to satisfy its fiduciary duty without periodically evaluating every fund provided the fiduciaries establish a core menu of funds that are evaluated on a periodic basis.

Record-Keeping Fee Models — Flat Fee or Revenue Sharing?

With respect to whether record-keeping services should be compensated using an asset-based or flat-fee model, it seems a couple of principles are fairly well settled: While a flat-fee model may be best practice (given that the cost of record-keeping and administrative services is a function of the number of participants and the services provided, not individual or aggregate account values), use of a revenue sharing model is not a per se violation of ERISA. That said, if fiduciaries choose to compensate a record-keeper, in whole or in part, through revenue sharing, they have a duty to carefully monitor the amount paid to ensure that the amount received does not exceed a "reasonable" amount, which leads me to the final point.

When Are Record-Keeping Expenses Excessive?

What must a complaint allege to state a breach of prudence claim based on excessive administrative expenses? It seems unlikely that the courts will embrace, without substantial modification, the standard used by courts under Section 36 of the Investment Company Act of 1940. However, it would seem that the allegations must at least allege that the plan's record-keeping fees were outside of the range of fees paid by comparable plans, which can be established through benchmarking and competitive bidding. There is no hard and fast guidance in the cases or otherwise for determining when the prudence

standard requires a fiduciary to engage in a full blown request for proposal, or RFP, process. Are the plan's record-keeping expenses within a range paid by comparable plans based on independent analysis and fee benchmarking? Are the fiduciaries and participants satisfied with the services being provided? A properly conducted RFP is time-consuming and expensive and so a cost benefit analysis should be conducted when the plan is footing the bill.

Arthur A. Marrapese III is a partner at Barclay Damon LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] Cunningham v. Cornell University (S.D.N.Y., Sept. 29, 2017).

[2] Sacerdote v. New York University (S.D.N.Y., Oct. 19, 2017).

[3] Cates v. Columbia University (S.D.N.Y., Oct. 20, 2017).