

ERISA 403(b) Lawsuits: Are Hospital Plans Sick and University Plans Dumb?

For the last 50 years or so, university and hospital retirement plans have been somewhat insulated from the fiduciary standard of care requirements, since 403(b) plans for the most part were operating outside of ERISA. Regulatory changes enacted in the past decade, however, have resulted in many more 403(b) plans becoming ERISA plans and the impact of the ERISA fiduciary requirements is now being felt. The two core fiduciary duties under ERISA are prudent investigation and always placing the interest of the participant first.

It is apparent that many of these plans, including some very large plans, were unaware of these fiduciary duties. The result of that is increased litigation with more than a dozen lawsuits being filed just this year. Plaintiffs assert that defendants breached their duties of loyalty and prudence in choosing some of these investment options. They allege many millions of dollars of damages. These suits are usually class action and thus impact many tens of thousands of employees.

The suits often allege various breaches of fiduciary duty, including high administrative fees, excessive underlying fund expense, improper revenue sharing payments, poorly performing “safe” cash investments such as money market funds, a confusing array of investment options and investments in underperforming funds.

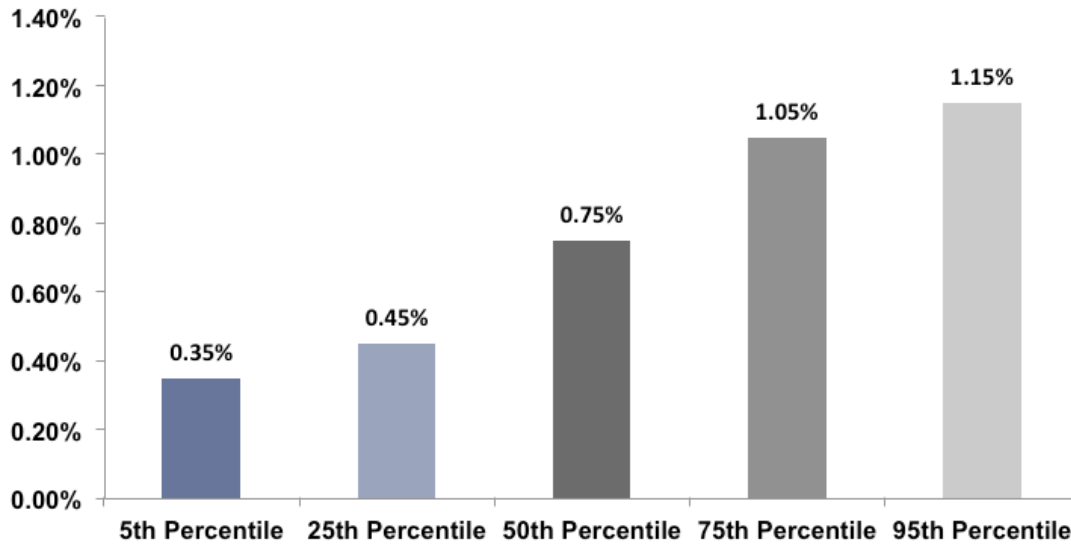
Noticeably absent from these suits are any allegations regarding retirement readiness. In other words, will the participant be able to replace their paycheck? The answer is, they don’t know. That’s because most of these plans do not measure participant outcomes or the effort that is necessary to improve outcomes. As a result, the plaintiffs have not been able to measure outcomes and include them in their lawsuits.

DETERMINING REASONABLE COSTS AND OUTCOMES

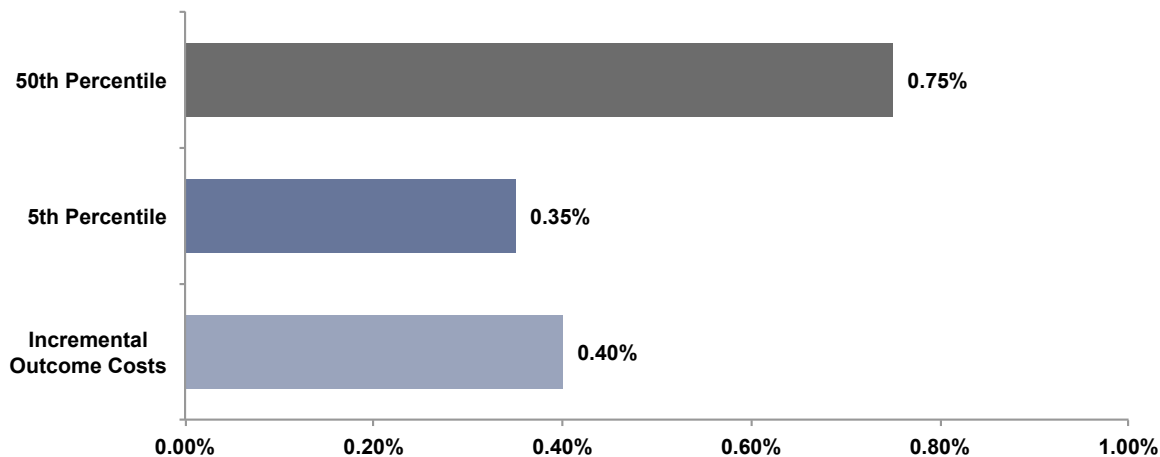
The lawsuits consistently focus on determining ‘the floor’ of minimum costs that they say a plan should incur. The plaintiffs typically do not discuss whether the plan costs are at the median, rather they seem to believe all plans are “commodities” of the same basic services and results. The plaintiffs also assume all the same outcomes in terms of retirement readiness and believe any costs above the floor “are wasted.” They seldom, if ever, mention differences in retirement readiness in their arguments.

The working theory of the Department of Labor (DOL) and plaintiffs is that there is an “absolute floor” of costs and each plan should be at this floor. They assume all outcomes are the same and all services and plans are simple commodities. A single basis point (0.01%) above the floor is unreasonable in their view. The chart below illustrates theoretical ranges of total plan costs by percentiles ranging from the 5th percentile at 35 basis points to the 95th percentile at 115 basis points, with a median of 75 basis points. The plaintiffs will only concern themselves as to whether or not the plan costs are very close to the floor or 5th percentile of 35 basis points in this example.

TOTAL PLAN COSTS BY PERCENTILES



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If their assumption is true then all plans should be at the floor in terms of costs. However ERISA requires the plan to be operated in the best interest of plan participants and that cost can be reasonable.

Assume a plan is at the 50th percentile and cost 75 basis points (0.75%). It is imperative to measure the difference between the actual plan costs and the potential floor of costs. We can call this difference “incremental outcome costs.”

In this example the cost difference between the 5th percentile and the 50th percentile is:

75 BASIS POINTS - 35 BASIS POINTS = 40 BASIS POINTS

Thus 40 basis points is the “incremental outcome cost.” This higher cost buys a certain amount of additional effort and should in turn produce improved outcomes. So it is not enough just to know cost nor is it enough to just buy additional effort. The plan sponsor must understand whether or not the additional effort made a difference.

With costs, effort and outcome all understood, only then are plan fiduciaries in a position to determine if costs are reasonable.

Costs need to be known but so do the units of effort and its impact on outcomes. With costs, effort and outcome all understood, the fiduciaries can then determine if costs are reasonable. This incremental outcome cost is reasonable if it is utilized solely in the best interest of plan participants and improves their outcomes. If participant retirement success outcomes are improved, than paying the 40 basis points is a reasonable cost because it benefits the participants. If participant outcomes are the same than the extra cost was not a worthwhile expenditure.

This incremental outcome cost must be measured and documented to show that it is reasonable. Many of the plans that are facing lawsuits today were completely unaware of these issues. They did not adequately investigate, had no documentation, and are now paying large settlements.

Poor investment performance, when viewed in isolation, is not sufficient to create a reasonable inference that plan fiduciaries failed to conduct an adequate investigation, either when the investment was selected or as its underperformance emerged. Indeed, a fiduciary may, and often does, retain investments through a period of underperformance as part of a long-range investment strategy. (See *Jenkins v. Yager*, 444 F.3d 916, 926, 7th Cir. 2006, whereby defendant did not breach fiduciary duties by retaining the same mutual funds in 401(k) plan lineup even though those funds lost money over a three-year period, as it can be reasonable “to stay with mutual funds even during years of lower performance”).

Recently the defense won a dismissal in one of the fiduciary fee reasonableness lawsuits. In *White v Chevron, et al.* Case No. 16-cv-0793-PJH U.S. District Court for the Northern District of California, 2016, the court ruled plan fiduciaries can value investment features and services on more than just price (and indeed, are required to do so). Thus the effort and outcomes are a key part of the analysis as well as cost.

“Fiduciaries have latitude to value investment features other than price (and indeed, are required to do so), as recognized by the courts.”

—*White v Chevron, et al.* Case No. 16-cv-0793-PJH U.S. District Court for the Northern District of California, 2016

Higher education and hospital plans should do the following:

- Understand their fiduciary duties and whether or not any of their vendor service providers are fiduciaries. In many cases the providers are not a fiduciary.
- Focus on participant outcomes
- Always place the interests of the participants first
- Make sure they know the cost, effort and outcomes for the metrics of their plan
- Ensure they are in compliance with the ERISA fee disclosure rules
- Follow the rules and procedures set out in the formal plan documents and any governance policies or benefit committee charters
- Periodically review the performance and fees associated with plan service providers
- Document their decision-making and any service provider or investment reviews, comparisons or benchmarking efforts
- Review the adequacy of any indemnification provisions in agreements with service providers and any investment managers or fiduciaries under ERISA Sections 3(16), 3(21) and 3(38)
- Consider hiring the highest ERISA fiduciary, a discretionary trustee.
- Review the adequacy of fiduciary liability insurance coverages for themselves as well as their fiduciaries and service providers