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Supreme Court Offers Mixed Guidance on Future of Lawsuits Challenging Investments and Fees in 401(k) and 403(b) Plans

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Ever since July 2021—when the U.S. Supreme Court announced it would review the Seventh Circuit's decision in the *Hughes v. Northwestern University* 403(b) excessive-fee class action—those working with or for retirement plans covered by ERISA have anxiously waited to hear what the Justices would have to say about these increasingly common cases. The Court's opinion here has the potential to offer guidance on the pleading standards and increase, or decrease, the tidal wave of such cases.

The original complaint was brought in 2016 by participants in Northwestern's two ERISA 403(b) defined-contribution plans. Participants alleged that Northwestern breached the fiduciary duty of prudence under ERISA by (1) incurring excessive recordkeeping fees through the use of two recordkeepers instead of one and failing to take steps to negotiate lower fees; and (2) causing participants to pay excessive investment fees by offering too many investment options and offering retail share classes when less expensive share classes for otherwise-identical investments were available.

The district court dismissed the complaint, finding that as a matter of law the participants failed to adequately allege a breach of fiduciary duty. Affirming the decision, the Seventh Circuit characterized the allegations as expressing merely the named plaintiffs' investment preferences. The Seventh Circuit emphasized that plan participants had the choice to select any of the lower-cost, conservative options the named plaintiffs favored out of the plans' variety of investment options on the menu.

The Supreme Court has now been asked to weigh in on whether the participants' allegations that a defined-contribution retirement plan paid or charged its participants fees that substantially exceeded fees for alternative available investment products or services are sufficient to state a claim against plan fiduciaries for breach of the duty of prudence under ERISA.

The Court's decision on this issue has broader implications than just for 403(b) plans because the issues raised are critical to defined-contribution plan excessive-fee litigation generally. Guidance from the Court on the pleading standards in these cases could affect the future of suits challenging fees paid in both 403(b) and 401(k) plans.

Highlighting the importance of the *Northwestern* case, the Court invited the solicitor general to file a brief, and 13 amicus briefs were filed on behalf of the parties. Amici for the participants included briefs from the solicitor general, investment law scholars, the Service Employees International Union, and AARP. Amici for Northwestern included a brief from the American Council on Education along with 17 other higher education organizations, the American Benefits Council, U.S. Chamber of Commerce, and Committee on Investment of Employee Benefit Assets. The Court also granted additional time for arguments, allocating 70 minutes total, and permitted the assistant solicitor general to argue on behalf of the participants.

During oral arguments, the Justices focused their questions on a variety of issues, highlighting the many different aspects of the case we may see addressed in the Court's eventual opinion.

Justices Kagan and Sotomayor appeared most sympathetic to the participants, pressing counsel for Northwestern on why the participants had not alleged enough to get their claims into court. On the other hand, Justices Breyer, Gorsuch, and Alito focused more on the particulars of the specific allegations in the complaint. The Justices took a close look at the participants' claims on the availability of cheaper institutional class shares or the reasonable fee for recordkeeping services, scrutinizing whether they had sufficiently alleged enough to meet the pleading requirements imposed by the Court's decisions in *Iqbal* and *Twombly*. In those decisions, the Court imposed a plausibility requirement in pleading, requiring a plaintiff allege sufficient factual allegations to support a reasonable inference that the alleged conduct occurred. After *Iqbal* and *Twombly,* a plaintiff's failure to allege sufficient, nonconclusory facts is subject to dismissal for failure to state a claim.

Chief Justice Roberts highlighted a separate issue, focusing on what the standard of "prudence" really means for fiduciaries. He questioned whether fiduciaries should be held to an "average" or the "highest" standard. To use a hypothetical, Chief Justice Roberts described a person trying to fill a car with gas who comes to an intersection with two gas stations. If one gas station at the intersection is offering gas significantly cheaper than the other gas station at the intersection, you would expect the person to go to the cheaper one. However, Justice Roberts expressed skepticism that you would expect that person to drive another 10 miles just to get even cheaper gas. This hypothetical illustrated in simple terms the very complex realities of fiduciary decisions and how far a fiduciary should be expected to go to obtain the best deal for participants.

A couple of Justices raised concerns about the implications of imposing too lenient of a pleading standard in these cases. Justice Breyer expressed the "dilemma" faced by fiduciaries: "If they have a lot of choices, you say you had too many choices, and if they have only a few choices, you say you had too few choices. And so whatever they do, you're going to say this was wrong." Justice Kavanaugh also expressed concern for the costly implications of a lowered pleading standard, acknowledging the reality that a plaintiff's claim surviving the pleadings stage places significant pressure on plan sponsors, fiduciaries, and insurance carriers to settle.

With the Justices focused on many different issues, there really is no way to read the tea leaves on how the Court will come out. Only one thing is clear: a unanimous opinion is unlikely. However, we have a few key takeaways that emerged from the Justices' questioning during arguments.

1. Offering a variety of investment choices is not a bad thing.

The Court generally agreed that choice is a good thing when it comes to defined contribution plans, and the Justices did not seem interested in weighing in on what is a prudent amount of choices in a plan. In particular, the Justices showed little support for the argument that Northwestern was imprudent for failing to consolidate the number of options available to plan participants. Justice Kagan, in questioning counsel for the United States, suggested that "there's a

value to the plan and having variety for the sake of variety." Justice Gorsuch described choice to participants as often being a "consumer good." We do not expect the Court to adopt a bright-line rule on the prudent range of investment options, but we anticipate language expressing the consensus that giving participants choice is a good thing.

2. *Offering both actively managed and passively managed funds on the investment menu is reasonable.*

In questioning counsel for Northwestern on the Seventh Circuit's holding, Justice Kagan affirmed that, even though an actively managed fund has higher fees than an indexed fund, "it's not unreasonable for a fiduciary to have both the managed fund with higher fees and the index fund with lower fees." Justice Kagan's questioning highlighted the understanding that comparing the fees for active funds to the fees for index funds is not a proper comparison when alleging excessive fees. Rather, fees must be compared between indexed funds and other indexed funds in determining the reasonableness of retaining certain investment options. We hope to see the Court reiterate Justice Kagan's point about the reasonableness of offering both actively managed funds and indexed funds and may see the Court take the opportunity to clarify that plaintiffs cannot allege unreasonable fees by comparing the fees of actively managed funds with the fees of indexed funds.

3. *Alleging that an "identical" share class was available "to the plan" is likely sufficient to survive a motion to dismiss.*

While the Justices were skeptical of the participants' claims on the imprudence of multiple recordkeepers or too many investment options, the questioning indicated that an allegation challenging expensive share class options is likely to be successful. The issue here is simply one of how it is pleaded. Is it enough to just say identical share classes are available generally? Or must the participants allege that such share classes were available to the plan? Indeed, with the Justices' receptiveness to the participants' allegations on this issue, we expect to see at least some of the participants' complaint survive and be remanded to the lower courts, perhaps with some guidance on the magic language necessary to state such a share class claim.

4. *Arguing that a fiduciary's subsequent changes to a plan supports an inference of imprudence creates a negative incentive for ERISA fiduciaries.*

Chief Justice Roberts expressed concern over the participants' arguments that Northwestern's subsequent changes to the plans supported the participants' allegations of imprudence, questioning whether allowing such an argument would "be creating an incentive not to fix things." We see it as wrong that a fiduciary's actions taken pursuant to the ongoing fiduciary duty to monitor the plan can be used against the fiduciary, at either the pleadings stage or otherwise. Fiduciaries should not be paralyzed in their decision-making out of fear of subsequent litigation. We hope that the Court will take this opportunity to reject the participants' attempt to use Northwestern's subsequent measures as evidence of prior imprudence.

We expect a decision from the Court closer to the end of the term, likely around April but possibly as late as June. We will continue to watch for the Court's decision and will update clients when an opinion is available.

In the meantime, please do not hesitate to contact your Alston & Bird attorney if you have any questions about the implications of the arguments or the forthcoming decision from the Court.

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