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Litigation in Defined Contribution Retirement Plans

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Summary

As the retirement industry contends with a new wave of fiduciary lawsuits, plan sponsors and advisor/consultant intermediaries continue to exert downward pressure on fees. In the 403(b) space, plan sponsors are compelled to consolidate recordkeepers and eliminate redundant investment options. Cerulli also notes that decision-makers in the defined contribution (DC) market tend to approach new and emerging strategies with an abundance of caution, which has implications for the adoption of in-plan guaranteed income products in 401(k) plans as well as environmental, social, and governance (ESG)-conscious investing.

Key Points

DC plan sponsors and providers operate in a fiduciary-conscious and fee-sensitive environment. For years, class action ERISA lawsuits have permeated industry headlines, with plaintiffs often claiming that 401(k) participants were subject to unreasonable investment and/or administrative expenses.

In recent years, class action lawsuits have also targeted large ERISA-covered 403(b) plans and smaller 401(k) plans (*i.e.*, with less than $1 billion in assets).

The pace of this litigation accelerated in 2020, and plaintiffs' arguments have evolved to address the role of plan service providers and use of participant data—not just fees. Cerulli maintains that process is more important than product in this context, and plan fiduciaries should thoroughly document their decision-making criteria.

Litigation alleging breaches of fiduciary duty under the Employee Retirement Income Security Act (ERISA) is hardly a novel phenomenon. However, class action litigation captured the spotlight in 2006, when Schlichter, Bogard & Denton (a St. Louis-based law firm) began filing lawsuits against large 401(k) plan sponsors. Fiduciary lawsuits may center on the use of company stock or newer, nontraditional investments, but most prevalent and well-known today are "excessive fee" cases. During the past decade, a growing number of complaints targeted plan sponsors' approach to monitoring investments, service providers, and their associated fees—claiming that participants paid unreasonable expense ratios and/or administrative fees.

In response to such litigation and broader industry trends, many defined contribution (DC) plan investment line-ups have been streamlined to reduce the number of funds and now feature low-cost, passive options, particularly among target-date funds serving as the Qualified Default Investment Alternative (QDIA). Within a given strategy, plan fiduciaries are often keen to secure the cheapest and most transparent share class available (*e.g.*, R6 mutual funds) or migrate to more cost-effective vehicles, such as collective investment trusts.

Retirement consultants and advisors frequently benchmark plan costs and conduct recordkeeper RFPs to ensure competitive pricing.

Company stock, which represented about 9% of all 401(k) assets in 2014, accounted for less than 4% of assets in 2018—and even plan sponsors with company stock on the menu are generally careful to communicate the benefits of diversification (while allowing participants to direct the investment of matching contributions). Further reflecting the emphasis on transparency, recordkeepers note that fewer plans are receiving "bundled" services (*i.e.*, in which recordkeeping fees are paid through the funds' expense ratios), with more arrangements charging a fixed dollar amount per participant. Retirement consultants and advisors, meanwhile, frequently benchmark plan costs and conduct recordkeeper requests for proposal (RFPs) to ensure competitive pricing.

Now, 15 years after the initial wave of headline-grabbing 401(k) class action lawsuits, what role will litigation continue to play in retirement plan decision-making, including investment selection?

A Cost of Doing Business

Plan sponsors are acutely aware of this risk of litigation; however, only 22% identify "minimizing fiduciary risk/avoiding litigation" as a top priority. While large plan sponsors are more likely to face class action lawsuits, they are slightly less focused on this issue than their small and mid-sized counterparts. Cerulli suggests that large companies are more focused on offering a competitive suite of benefits and view potential litigation as just another cost of doing business. Moreover, corporations with dedicated human resources (HR), benefits, and legal staff are likely better equipped to respond to lawsuits effectively, without disrupting day-to-day operations. That said, one attorney specializing in employer benefits notes that "It's not just the financial cost, which may be covered by fiduciary liability insurance—plan sponsors also have to think about the time and drain on resources." Such cases can easily take years to resolve.

401(k) Plan Sponsors: Top Priorities for 401(k) Plan, 2019

Only one-fifth of plan sponsors identify "minimizing fiduciary risk/avoiding litigation" as a top priority.

	Plan Asset Segments							
Priority	<$5m	$5m–$25m	$25m–$100m	$100m–$250m	$250m–$500m	$500m–$1b	≥$1b	All Plan Sponsors
Improving overall financial wellness of employees	47%	43%	39%	43%	43%	44%	48%	43%
Maximizing participant savings (*e.g.*, increasing participation and contribution rates)	43%	41%	44%	43%	36%	44%	40%	42%
Maintaining a competitive retirement benefit in our peer group	33%	38%	35%	35%	44%	46%	25%	36%
Reducing plan administration and investment management costs	37%	27%	34%	27%	33%	31%	43%	32%
Retirement readiness education (*i.e.*, preparing employees to retire when they want to)	20%	26%	30%	43%	25%	31%	20%	27%
Improving quality of investment lineup	25%	25%	27%	34%	26%	21%	38%	27%
Minimizing fiduciary risk/avoiding litigation	19%	30%	21%	20%	13%	19%	20%	22%
Adding or encouraging use of an in-plan retirement income option (*e.g.*, managed payout, guaranteed annuity)	17%	21%	18%	20%	23%	32%	28%	21%
Navigating new regulations/legislation	14%	16%	18%	15%	16%	16%	13%	16%

Source: Cerulli Associates | Analyst Note: Respondents were asked to select up to three priorities.

In an effort to mitigate risk and outsource investment-related decision-making, more plan sponsors are seeking advisors to act in a 3(38) fiduciary capacity—that is, with discretionary oversight of the plan's investment menu. Furthermore, with the Setting Every Community Up for Retirement Enhancement (SECURE) Act passing in December 2019, employers will soon have the option to join a Pooled Employer Plan (PEP) without needing to fulfill any "common nexus" requirement; PEPs will feature service providers acting in a variety of fiduciary roles. With much speculation as to whether the PEP market will cannibalize traditional 401(k) business, some industry stakeholders suggest that plan sponsors wary of lawsuits will gravitate toward this solution.

However, Cerulli holds that neither engaging a 3(38) fiduciary nor joining a PEP necessarily absolves plan sponsors of liability. Plan sponsors remain responsible for selecting an advisor/consultant or Pooled Plan Provider (PPP) and monitoring their services. In a 401(k) complaint filed in May 2020, plaintiffs accused Schneider Electric (the plan sponsor) and Aon Hewitt (the plan's investment consultant) of charging unreasonable fees and steering participants toward funds without a sufficient track record. The lawsuit further claims that implementing Aon's proprietary target-date series as the QDIA represents a conflict of interest.

From the asset managers' perspective, plan sponsors' fear of litigation is generally seen as "somewhat of a challenge" or simply "not a challenge" for their defined contribution investment-only (DCIO) sales. However, other key challenges—including the increased demand for passive funds and downward pressure on investment management fees—are likely amplified by the proliferation of excessive fee lawsuits. In that light, it is not surprising that asset managers most often identify "litigation against DC plan sponsors and their providers" as having a negative overall impact on DCIO business.

Challenges to DCIO Sales, 2019

DCIO asset managers identify the demand for passive funds and pressure on investment fees as major challenges.

Challenge	Not Applicable	Not a Challenge	Somewhat of a Challenge	Major Challenge
Increased demand for passive funds	0%	16%	22%	62%
Pressure on investment management fees	0%	3%	38%	59%
Increasing contributions to target-date funds	0%	46%	19%	35%
Plan sponsor inertia	3%	8%	73%	16%
DC plan menu consolidation	5%	30%	54%	11%
Firm's best-performing funds in asset classes not typically used in DC plans	8%	70%	11%	11%
Plan sponsor fear of litigation	0%	38%	54%	8%
Lack of resources to develop relationships with all decision-makers	0%	51%	43%	5%
Investment performance/not meeting screening criteria	0%	49%	49%	3%
Recordkeeper consolidation	0%	54%	46%	0%

Source: Cerulli Associates | Analyst Note: Data is sorted by "major challenge."

A Barrier to In-Plan Retirement Income

The threat of litigation is widely acknowledged as a barrier to in-plan retirement income, particularly guaranteed income. Another provision of the SECURE Act grants plan sponsors an ERISA "safe harbor" when selecting an annuity provider, provided certain licensing and solvency requirements are met. Asset managers relate growing interest but only limited adoption of these products within 401(k) plans—guaranteed income remains subject to higher fees than most other DC investments, and the COVID-19 pandemic delayed strategic retirement initiatives for many plan sponsors.

As 401(k) plan sponsors and their intermediaries contemplate the role of in-plan retirement income solutions—not to mention the use of private equity or environmental, social, and governance (ESG)-conscious investing—fiduciary lawsuits are gaining momentum.

The unique nature of litigation against higher education 403(b) plans may address the role (and expense) of multiple recordkeepers, duplicative investment options, or the inflexibility of certain annuity products.

According to the Center for Retirement Research at Boston College (referencing Bloomberg's ERISA Litigation Tracker), the number of complaints aimed at 401(k) plans started trending upward after 2013. DeMario Carswell, an attorney with Goodwin, observes that more than 50 class action ERISA lawsuits relating to DC plans were filed in the first seven months of 2020—well exceeding the 32 filed in all of 2019.

Another ERISA attorney comments that, "These law firms are starting to copy each other; you have a formula in place now where it's just a matter of taking the same arguments and changing a few key words...plenty of these cases won't ever go to trial, but if you can survive the motion to dismiss and things keep dragging on, then you've got a decent chance at a settlement." Cerulli notes that while the largest plan sponsors (those overseeing plans with billions in assets) are generally the target for class action retirement litigation, the past few years have brought forth a handful of cases targeting sub-$1 billion and even sub-$500 million plans.

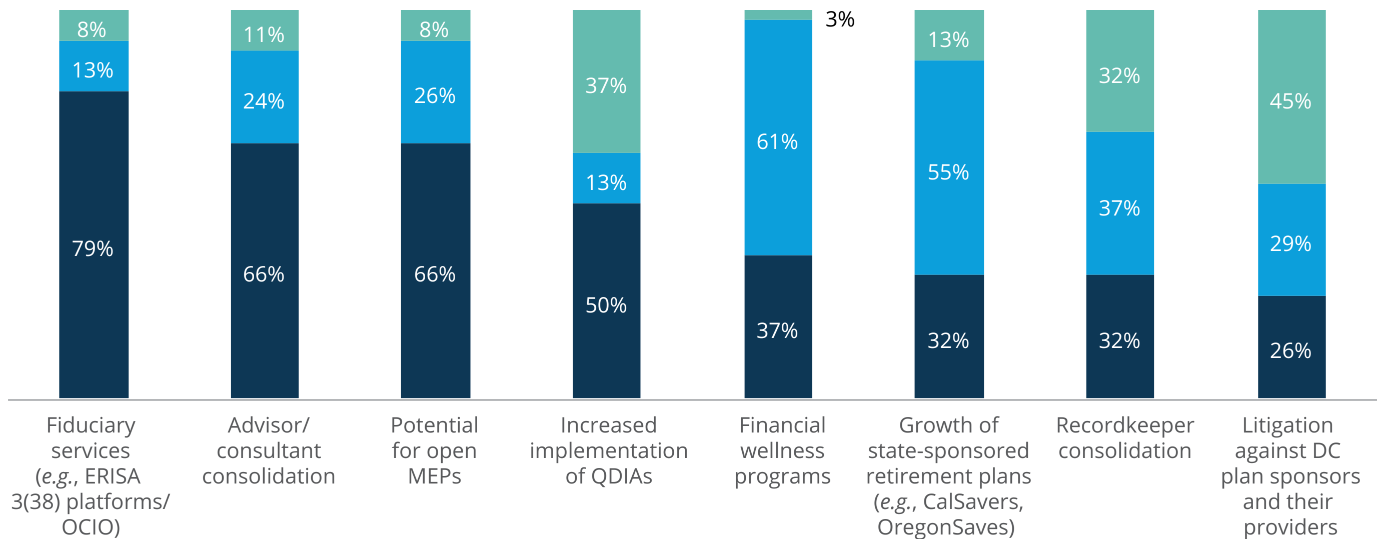
Such lawsuits have also extended beyond the 401(k) universe to focus on other plan types. Large universities, including Columbia, Duke, Johns Hopkins, NYU, and Princeton have also come under scrutiny, with a wave of ERISA 403(b) plan litigation starting in 2016.

Given the unique nature of higher education 403(b) plans, these cases may address the role (and expense) of multiple recordkeepers, duplicative investment options, or the inflexibility of certain annuity products. In an effort to achieve economy of scale and streamline operations, some 403(b) plan sponsors have conducted special RFPs to reduce the number of recordkeeper choices for participants.

Impact of DC Market Trends on DCIO Business, 2019

Asset managers are most likely to view litigation against DC plan sponsors as a negative influence on DCIO business.

■ Positive impact ■ No impact/not applicable ■ Negative impact



Source: Cerulli Associates

Participants' Willingness to Provide Personal Data, 2020

Participants are generally more comfortable sharing demographic data than information pertaining to health or debt.

Data Point	Not Applicable	Uncomfortable	Somewhat Comfortable	Very Comfortable
Gender	5%	7%	18%	71%
Ethnicity	10%	11%	19%	60%
Family structure (e.g., spouse, children)	8%	10%	27%	56%
Expected retirement age	10%	9%	26%	56%
Smoking status	30%	10%	11%	48%
Gross income	3%	13%	38%	46%
401(k) account balance	4%	16%	35%	45%
Credit card debt	12%	21%	29%	38%
Weight/BMI	11%	27%	28%	34%
Chronic health conditions	15%	25%	28%	32%
Student loan debt	43%	9%	16%	32%
Non-401(k) assets	10%	26%	34%	30%

Source: Cerulli Associates | Analyst Note: This question was asked to both active and retired 401(k) plan participants. Respondents were asked to rate their willingness to provide personal data to their 401(k) provider(s). Respondents were told to assume that the data would be used to personalize their investment advice and/or financial wellness experience, and that the information would NOT be shared with their employer.

Even non-ERISA DC plans have appeared in recent headlines; however, these complaints take on a very different flavor. In 2019, the Securities and Exchange Commission began examining sales practices in K-12 and governmental plans (typically non-ERISA 403(b) and 457 plans), questioning administrators' compensation, investment recommendations, and the cost of both mutual fund and annuity options.

In July 2020, Valic agreed to a combined $40 million settlement following claims that the firm failed to disclose payments made to an entity affiliated with Florida teachers' unions, and that advisors did not acknowledge conflicts of interest associated with more expensive mutual fund options.

Cybersecurity and Data Privacy Also Hot Topics

While fees and expenses remain at the forefront of retirement plan litigation, other concerns have been raised in recent lawsuits, such as cybersecurity and data privacy. In this context, service providers—not just plan sponsors—may also find themselves subject to ERISA complaints. A recent case brought against Shell Oil Co. and Fidelity, the plan's recordkeeper, claimed that Fidelity leveraged confidential participant data to market retail financial products. As part of a 2020 suit brought against Abbott Laboratories, Alight Solutions, and others, plaintiffs argue that a customer service representative at Alight failed to properly authenticate a caller, resulting in a fraudulent transfer out of one participant's account.

In a notable case brought against Vanderbilt University's 403(b) plan, plaintiffs challenged the use of multiple recordkeepers, retail share classes, and revenue-sharing agreements while alleging that TIAA misused participant data to sell wealth management services.

The case settled for close to $15 million, with one provision of the settlement limiting service providers' use of data—the agreement stipulates that recordkeepers must refrain from marketing out-of-plan products and services. Lawyers generally agree that while participant data remains a sensitive and stressful issue, there are no regulations or court decisions classifying such data as a "plan asset." Cerulli suggests that recordkeepers, managed account providers, and advisor/consultant intermediaries should clearly articulate the scope

Besides a laser-like focus on fees, plan sponsors and intermediaries look for products with an established (5-year+) track record.

of data being collected, intended uses for the data, and security measures in place to protect confidential information. On a related note, some participants express a willingness to provide additional personal information if it leads to a more customized experience; others remain wary and place more emphasis on privacy.

In a controversial proposed rule issued in June 2020, the Department of Labor (DOL) questioned the role of ESG factors in ERISA-covered retirement plans, stressing the importance of taking only "pecuniary" factors into consideration when selecting investments. While ESG advocates point out that these strategies outperformed during the volatility of early 2020 and may better identify/mitigate certain risks, the DOL's proposal (and simultaneous investigation of plans offering ESG-themed funds) effectively discourages the practice of ESG investing. As a result, plan decision-makers may shy away from these options if they are perceived as posing additional risk, or if the process of justifying ESG investments proves overly cumbersome.

Plan sponsors possess a heightened awareness of their fiduciary obligations and the potential for litigation; understandably, they generally take a cautious and conservative approach to investment selection.

Besides a laser-like focus on fees, plan sponsors and intermediaries look for products with an established (5-year+) track record. For asset managers, this makes the DC market a challenging environment, one that is slow to evolve.

While participants have undoubtedly benefited from the additional scrutiny of investments and downward pressure on fees, opportunities still remain to improve upon the DC experience—for example, by facilitating in-plan retirement income, evaluating the impact of ESG factors, or leveraging participant data to deliver more personalized solutions. Meanwhile, the ever-present threat of litigation casts a shadow over plan sponsors considering less mainstream offerings.

Cerulli notes that innovation in the DC space tends to originate with the "mega" market. Large employers often view their benefits package as an essential tool for recruitment and retention. They also have the buying power to facilitate more custom arrangements—as well as support from sophisticated HR/benefits departments, investment committees, consultants, and legal resources to articulate retirement plan strategies and respond to litigation.

Most importantly, Cerulli reminds retirement practitioners that there is no established list of superior or "safe" products and services. Instead, it remains critical for fiduciaries to follow a prudent process and clearly document their decision-making criteria when evaluating providers, negotiating fees, or selecting and monitoring investments.

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