COMPLIANCE

University of Pennsylvania Wins Dismissal of Case Against 403(b)

The case had challenged multiple recordkeepers, multiple investment options and the use of retail share class funds.

By Rebecca Moore EDITORS@STRATEGIC-I.COM | September 22, 2017

U.S. District Judge Gene E. K. Pratter of the U.S. District Court for the Eastern District of Pennsylvania dismissed all claims against the University of Pennsylvania and its vice president of human resources that they violated their fiduciary duties under the Employee Retirement Income Security Act (ERISA) by causing 403(b) plan participants to pay excessive fees and by offering an array of investment choices, many of which the plaintiff says underperformed.

The lawsuit filed last year claims the defendants breached their fiduciary duty by "locking in" plan investment options into two investment companies, allowing administrative services and fees that were unreasonably high due to the defendants' failure to seek competitive bids to decrease administrative costs, and allowing unnecessary investment fees to be charged while the portfolio underperformed.

The court opinion notes that at the end of 2014, the plan had $3.8 billion in net assets and 21,412 participants, making it among the largest 0.02% of defined contribution (DC) plans in the United States based on total assets. In addition, Pratter noted in her opinion that the university's plan has a diverse array of beneficiaries to serve, from grounds and cleaning crews to renowned Wharton School and Law professors, physicists, anthropologists, hockey coaches and endless others. "These individuals have different goals, risk tolerances, investment acumen and income," she wrote. "To make it easier for potential investors, plan managers divided the investment options (which ranged between 76 and 118 options) into four tiers. Tier 1 is for the "do it for me" investor; tier 2 is geared toward the "help me do it" investor; tier 3 is designed for the "mix my own" investor; and tier 4 is built for the "self-directed" investor."

"The touchstone of an effective ERISA defined contribution plan is if it 'offer[s] participants meaningful choices about how to invest their retirement savings,'" Pratter said, citing previous case law. "Such a duty to offer choice is more pronounced in plans as large as Penn's, which serves a broad array of needs and desires."

Several times in her opinion, Pratter cites ***Renfro v. Unisys Corp.***, in which plaintiffs challenged "the selection and periodic evaluation of the Unisys defined contribution plan's mix and range of investment options" in a 401(k) plan. In upholding the dismissal of the claim, the 3rd U.S. Circuit Court of Appeals held that courts must look to the "mix and range of options and . . . evaluate the plausibility of claims challenging fund selection against the backdrop of the reasonableness of the mix and range of investment options." Under that framework, the court concluded that in light of the available options—which included 73 investments with fees ranging from 0.10% to 1.21%—plaintiffs had "provided nothing more than conclusory assertions" of fiduciary breach and it affirmed dismissal of the case.

The opinion includes a summary of the history of retirement plans and concedes that 403(b) plans pre-date 401(k) plans by about 20 years. It notes that 403(b) and 401(k) plans for years differed dramatically in both scope and structure. For one thing, 403(b) plans initially were limited to annuity contracts. Pratter said that even if governed by ERISA, these salient differences resulted in different management and fiduciary requirements, since the duties by a fiduciary to an annuity contract differs dramatically from the duties of a fiduciary managing mutual funds. However, she noted that 403(b) plans have moved away from annuity offerings to offer a range of options that are similar to those offered by 401(k) plans, and fiduciary requirements by 403(b) plan administrators are nearly identical to those requirements for 401(k) administrators.

Addressing the Claims

The plaintiff's first claim is that by "allowing TIAA-CREF to mandate the inclusion of the CREF Stock Account and Money Market Account in the Plan" the defendants committed the plan to an "imprudent arrangement in which

certain investments had to be included and could not be removed from the plan" even if the investments underperformed. In support of this assertion, the plaintiff points to a Supreme Court decision in ***Tibble v. Edison Int'l***, in which the court noted that "under trust law, a fiduciary normally has a continuing duty of some kind to monitor investments and remove imprudent ones."

Pratter concluded the plaintiffs' complaint fails to allege conduct that violates the ***Tibble*** principle. The only fact that she pled is that the defendants "locked in" the plan to TIAA-CREF. "This, standing alone, is insufficient to create a plausible inference that this was a breach of fiduciary duty," Pratter wrote, noting that locking in rates and plans is a common practice used across the business and personal world. Companies often offer better terms to induce customers to "lock in" for a longer period.

The next claim is that the defendants allowed TIAA-CREF and Vanguard to charge unreasonable administrative fees in two ways: First, allowing TIAA-CREF and Vanguard to operate as their own recordkeepers (rather than consolidating all funds with a singular third-party recordkeeper) supposedly increased fees; and second, that the plan administrators should have arranged a flat per-person fee rather than an "asset-based" fee.

Pratter decided the argument that TIAA-CREF and Vanguard operated as their own recordkeepers fails for similar reasons to the "locked in" claim. What she called "bundling of services" she said is not inconsistent with lawful, free market behavior in the best interests of those involved, including beneficiaries. "Here, it is rational to comply with Vanguard's requirement that they serve as recordkeeper if that is required to gain access to the desired Vanguard portfolio," Pratter wrote.

But even if this were not true, she said the argument also fails as a factual matter because there is a reasonable "range of investment options with a variety of risk profiles and fee rates," citing ***Renfro***. In the present case, the fees range from 0.04% to 0.87%, markedly lower than the 0.10% to 1.21% at issue in ***Renfro***. The plan offered 17 investment options with fees lower than the lowest fees in Renfro (0.10%) and only one plan above 0.57%. "With such low fees, it is not inevitable to say that recordkeeping fees were unnecessarily high, especially when there are rational bundling reasons to allow separate recordkeepers," Pratter wrote. "Even if there were cheaper options available for recordkeeping fees, ERISA mandates that fiduciaries consider options besides cost. Fiduciaries must balance 'providing benefits to participants and their beneficiaries' and 'defraying reasonable expenses of administering the plan,'" again citing ***Renfro***.

Rejecting excessive fee and prohibited transaction claims

Pratter uses this "fiduciary balance" argument to reject many of the claims in the case, including the claim that the plan should have charged per-participant rather than asset-based fees. "The plan administrators are fiduciaries to every plan member, whether she invests $10 or $10 million. It is not up to courts to second-guess how fiduciaries allocate that cost, only that the fiduciary 'discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries'" as a whole," she wrote.

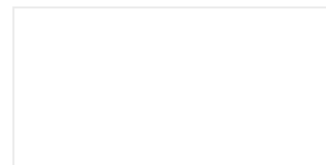
Pratter also said the majority of the "excessive fee" arguments fail to state a claim because the mix and range of fee options included fees as low as 0.04%, which neither side claims is excessive. The strongest argument advanced by the plaintiffs is that the plan contained "retail class" shares, rather than other identical options with lower fees, known as "institutional class" shares. But, the judge decided the plaintiffs overstate their argument. While some shares in the plan are retail shares that could be replaced with institutional shares, nearly half of the shares (37 of 78) are already lower-fee funds. She noted that the plaintiffs' argument also ignores that these institutional class shares would only be available if significantly more money were funneled into each of them. Switching from retail to institutional shares is not a matter of checking a different box. It requires fiduciaries to balance the menu of options given to plan beneficiaries against the fees. Sometimes, institutional shares are unavailable as an option because investment levels are too low in that fund. And, Pratter points out, institutional investment vehicles also come with a drawback: lower liquidity, citing ***Loomis v. Exelon Corp***.

Pratter also rejected the plaintiff's allegation that defendants "provided a dizzying array of duplicative funds in the same investment style" leading to "'decision paralysis' for participants." She found the plaintiffs have not alleged any participant who was confused by the different options. In addition, the plan administrators broke the options down into four categories based on the participants' investment acumen to help guide them. "Offering 78 different choices is not an unreasonably high number, especially with the tiered descriptive guidance given to participants," she wrote.

The plaintiffs' derivative claim, namely that offering duplicative funds was unnecessary, fails as well, Pratter said. On the contrary, duplicative investment options are necessary based on the structure of the plan, and the fact these tiers contained some of the same funds is unsurprising and raises no plausible inference of a breach of fiduciary duty. "Indeed, if there was no overlap there could be greater cause for criticism or frustration," she wrote.

Finally, the plaintiff claims that select funds were outperformed by the rest of the market, claiming that 60% of the plan's investment options "underperformed their respective benchmarks over the previous five-year period." To begin, Pratter said there is no cause of action in ERISA for "underperforming funds." The statutory text requires fiduciaries to discharge their duties "with the care, skill, prudence, and diligence under the circumstances then

prevailing" when they make decisions. The plan administrator deserves discretion to the extent its ex ante investment choices were reasonable given what it knew at the time, she ruled.



In addition, when examined closely, the plaintiffs' claims do not withstand scrutiny, according to the opinion. A statistical sampling of funds would expect (all things being equal) half of the funds to be above benchmarks and half to be below benchmarks. Here, as opposed to what the simplistic statistical average would show, that 38 (half) of the 76 funds underperformed, the plaintiffs pled that 45 investment options performed below benchmarks. "Such a post hoc analysis of market performance, where only 7 more funds underperformed than would be expected, may be consistent with a breach of fiduciary duty, but does not show that the plaintiffs have nudged their claims across the line from conceivable to plausible." Pratter wrote.

The plaintiff seeks recovery for prohibited transactions under ERISA using the theory that the contractual arrangement with TIAA-CREF and Vanguard constituted a prohibited transaction. The plaintiff argues that paying these companies constitutes a sale of property, a furnishing of services, and a transfer of assets in the plan. "If such an argument were true, then any time plan administrators contracted with another party to provide services to plan participants in exchange for money (which includes the basic elements of retirement plans, including making mutual funds available or recordkeeping services) it would qualify as a prohibited transaction. After all, fees charged by these companies necessarily requires 'transfer of assets,'" Pratter wrote, noting that the plaintiff claims this all while maintaining that there are no per se ERISA violations in the revenue-sharing arrangement.

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