December 2016

The Wave of Retirement Plan Litigation: A Primer

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Introduction

Retirement plan litigation has heated up in 2016 with at least 25 new cases being filed in the United States, including against 12 universities (such as Yale and MIT) as well as financial and non-financial institutions (including Morgan Stanley, Wells Fargo, American Century, Oracle and Northrop Grumman).

These types of cases, however, are not new. Over the past decade, at least 14 corporations have settled similar lawsuits for a total exceeding $360 million (see Addendum). In this primer, we review a sample of 31 cases filed since the start of 2015: 13 against financial services companies, 6 against non-financial companies, and 12 against universities. Among the cases reviewed, all but one have survived motions to dismiss, although some claims have been removed.

Cases Reviewed		
Financial Institutions	**Non-Financial Corporations**	**Universities**
Urakhchin v Allianz Asset Management of America	*Main v American Airlines, Inc.*	*Cates v Columbia*
Wildman v American Century	*Bell v Pension Committee of ATH Holding Company, LLC (Anthem)*	*Cunningham v Cornell*
Bowers v BB&T (lead case); Smith v BB&T	*White v Chevron Corporation*	*Clark v Duke*
Moreno v Deutsche Bank Americas Holding Corp	*Johnson v Fujitsu Technology and Business of America, Inc.*	*Henderson v Emory*
McDonald v Edward Jones	*Marshall v Northrop Grumman Corp.*	*Kelly v Johns Hopkins*
Cryer v Franklin Resources, Inc. (Franklin Templeton)	*Troudt v Oracle Corporation*	*Tracey v MIT*
Habib v M&T Bank		*Divane v Northwestern*
Patterson v Morgan Stanley		*Sacerdote v NYU*
Bekker v Neuberger Berman		*Sweda v Penn*
Andrus v New York Life		*Munro v USC*
Brotherston v Putnam Investments		*Cassell v Vanderbilt*
Richards-Donald v TIAA		*Vellali v Yale*
Meiners v Wells Fargo		

Background

In the cases reviewed here, company employees, who are investor-participants in the retirement plans offered, argue that the retirement plan investments made available to them by their employers are more costly than need be, and that the options being made available to them are suboptimal.

The plaintiffs generally contend that in being required to pay fees that are too high and being exposed to poor performing investment choices, their retirement packages will be less valuable than otherwise expected, to the tune of millions of dollars.

The cases have been filed under ERISA, which sets minimum standards for the prudent provision of employer-sponsored retirement plans, prohibits self-dealing, and demands that fiduciaries put the interests of plan participants ahead of their

> **"… an employer is required to monitor the manager periodically to assure that it is handling the plan's investments prudently ..."**
>
> — Department of Labor

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own.[a] The employee-plaintiffs, then, allege that their employers have failed in fulfilling their fiduciary duties and duties of loyalty and prudence, and on occasions have allowed conflicts of interest to undermine the independence or objectivity of their decision-making processes.

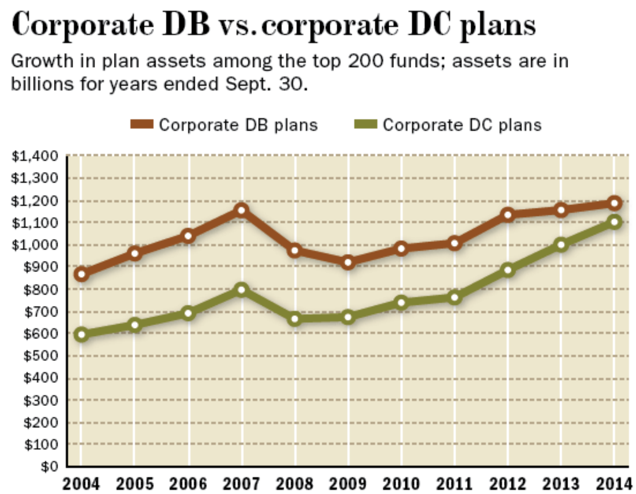
There are two basic types of employer-sponsored retirement plans: defined benefit (DB) and defined contribution (DC) plans.

DB plans are more traditional pension plans, in which future benefits are calculated ahead of time (often based on years of service and average salary) and employers are responsible for funding their employee pension liabilities. Employers are exposed to investment risk, and if their pension investments perform poorly, they may need to contribute more to the plan, eroding company profits.

Conversely, DC plans place the burden on employees to fund their own retirements by withholding current income to invest in their own retirement savings, tax-deferred.

It is the proper administration of DC retirement plans that is central to the concerns here, and the scale of the problem is growing. As shown in the accompanying graphic, retirement assets are progressively shifting towards DC plans as large corporations move away from or wind down their DB retirement plan exposures.

It is increasingly incumbent on individuals to make their own choices regarding how much current income to forego in order to fund their retirement and how to allocate those funds. Although the employee chooses how to invest his retirement savings, he is confined to the options made available to him by his employer.



http://www.pionline.com/article/20150209/PRINT/302099986/corporate-retirement-plans-near-tipping-point

Mechanics of DC Plans

DC plans, often referred to as 401(k) plans – or 403(b) plans in the not-for-profit sector, including the education sector – vary in their particular dynamics, but they generally take the same basic structure. The sponsor, or employer, is ultimately responsible for the plan. Even if an employer outsources all aspects of the plan, it remains, per the Department of Labor, duty-bound to monitor the vendors it hires, to ensure that the plan is being run according to ERISA's terms.[b]

Most DC plans follow a similar blueprint. The sponsor hires a recordkeeper to handle the administrative aspects of the plan, a trustee/custodian to hold and distribute plan assets, and investment managers to offer various investment choices.

Companies can opt for a bundled approach, in which one vendor provides all of these services, or they can choose each service provider separately. Some financial services or asset management firms (and their subsidiaries) run

[a] According to the Department of Labor, the "Employee Retirement Income Security Act of 1974 (ERISA) is a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans." See, for example, the following links: https://www.dol.gov/general/topic/health-plans/erisa
https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/fsfiduciary.pdf
[b]https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/meetingyourfiduciaryresponsibilities.pdf

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every major aspect of their employee retirement plans, despite the fact that doing so can expose them to charges of conflicts of interest or self-dealing.[c]

Allegations

Retirement plan participants' central arguments concern the high fees they pay and the suboptimal investment choices they are offered.

The allegedly excessive fees arise in the plans' administrative services and investment management; they can also be magnified if sponsors fail to seek out cost-efficient providers, effectively negotiate with providers for optimal treatment – or from sponsors' self-dealing, with companies populating their retirement plan options with their own (relatively overpriced) offerings. Plaintiffs also allege that they are limited to poorly performing investment choices, with the sponsors failing to properly monitor the plans or, here again, due to self-dealing.

We elaborate on the issues raised by plaintiffs in the following sections.

Inflated Recordkeeping Fees

Plan participants argue that they are being subjected to excessive recordkeeping fees.

Recordkeeping is a mundane function, in which service providers are tasked with administrative duties from keeping track of investment inflows and outflows to mailing periodic statements: the cost of providing the service would be identical for an account of $1 or $100 million.

According to an October 2015 report by investment consulting firm NEPC, fees tend to be significantly lower when based on a fixed cost per participant, rather than asset-based.[d] Since the cost of performing these services does not vary with the size of the investment account and the market for recordkeeping services is competitive, many retirement plans have been shifting towards the cheaper option of paying recordkeeping fees on a per-account basis, instead of as a percentage of assets.[e]

With these factors in mind, the plaintiffs argue that their fees should have been allocated at a fixed charge per participant, rather than a percentage of assets, which generally grow over time. They are particularly concerned about asset-based recordkeeping costs.

Asset-based recordkeeping fees often take the form of revenue sharing arrangements between the mutual fund and the recordkeeper, according to which a portion of the mutual fund's asset management fees are sent to the recordkeeper to pay for its services. This type of revenue sharing can be problematic for participants because as assets grow in size (due to investment gains and additional contributions), the asset-based fees increase in dollar terms, causing recordkeeping fees to grow to amounts that are orders of magnitude beyond what (the plaintiffs) might consider *reasonable*. Many plaintiffs allege that the plan sponsors are required to monitor the revenue sharing arrangements to ensure that any unreasonable amounts directed to the recordkeepers be returned to the participants.

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[c] https://www.aaii.com/journal/article/understanding-401-k-mechanics-a-look-at-how-the-plans-operate
[d] http://www.nepc.com/writable/research_articles/file/2015_10_nepc_2015_defined_contribution_plan_and_fee_survey-_what_a_difference_a_decade_makes_copy1.pdf
[e] https://www.shrm.org/resourcesandtools/hr-topics/benefits/pages/401k-fees-fixed-dollar.aspx

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Recordkeeping fees, like any fees, can add up. For example, in *Cassell v. Vanderbilt*, the plaintiffs claim that unreasonable recordkeeping fees have cost them over $25 million.[f]

A typical complaint might contend that for a given size retirement plan (in terms of the number of participants), recordkeeping fees should be in a range of $x to $y, as larger plans should be able to negotiate lower fees for their participants, given their increased bargaining power. In *Vellali v. Yale*, for example, the plaintiffs claim that their recordkeeping fees should have been roughly $35 per participant, instead of the $200-$300 that participants paid.

Citing studies concerning retirement plan fees,[g] some plaintiffs also claim that utilizing multiple recordkeepers results in higher fees. The predominant argument being made is that plan sponsors could minimize costs by contracting with only a single recordkeeper, thereby taking advantage of a single and larger offering to negotiate fee arrangements from a more powerful position.[h]

> Plan participants argue that sponsors could decrease costs by contracting with only a single recordkeeper. A larger offering, then, would arguably allow for the adoption of a stronger negotiating position when entering fee discussions.

Failure to Negotiate for (Preferential) Mutual Fund Share Classes

In addition to the recordkeeping fees that pay for administrative tasks, investors pay for the professional management of their actual investment choices. Those costs take the form of mutual fund expense ratios. These fees are almost always asset-based, charged as a percentage of assets being managed by a particular investment fund. The percentage charged ranges from a few basis points (for certain index funds) to a few percentage points (for some higher-priced retail class actively-managed funds).

Within a given investment choice (e.g. BlackRock Inflation Protected Bond A) there are typically two classes of share offerings – retail and institutional. Per *Kruger v. Novant Health*, for the aforementioned BlackRock fund, the retail share class pays an annual management fee of 86 bps, or 0.86% per annum, while the institutional share class pays only 43 bps. Aside from fees, the investment product itself is identical in every way – an investment with the same manager, in the same strategy and portfolio of securities. As the names suggest, retail shares are offered to individual retail investors, who typically invest smaller amounts than institutional investors, such as pension funds and university endowments.

Many plaintiffs argue that the plans offered to them were for suboptimal *retail* share classes of mutual funds, instead of lower cost *institutional* share classes; this distinction, they say, required them to pay higher investment management fees, and yielded no advantages. Plaintiffs argue that, given the size of the retirement plans and the aggregate amounts being invested in each fund, sponsors should have insisted on gaining access to institutional classes, instead of retail classes, thereby lowering the fees being taken by investment managers from the members of the class.

Somewhat related to this issue – and analogous to the single versus multiple recordkeeper argument – some plaintiffs argue that sponsors are offering too many investment choices. They argue that by spreading assets among many different investment options within the same asset class and style (e.g. large cap growth equities), the plan forgoes the opportunity to leverage its size to negotiate preferential asset management fee arrangements.

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[f] *Cassell v Vanderbilt* complaint at p. 30: "Plan losses have been brought forward to the present value using the investment returns of the S&P 500 index to compensate participants who have not been reimbursed for their losses. This is because the excessive fees participants paid would have remained in Plan investments growing with the market."
[g] See this link, for example: https://retirementandinvestmentblog.aon.com/getattachment/36ff81a4-db35-4bc0-aac1-1685d2a64078/How_403
[h] The plaintiffs in *Vellali v Yale* make this allegation, although they maintain that the recordkeeping fees were still excessive even after Yale had switched from multiple recordkeepers to just one.

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Offering Active vs. Passive Funds

Several plaintiffs argue that passive investment options should have been offered, either along with or in place of, actively-managed funds, which have higher fees. Among investors, there is an ongoing argument regarding active versus passive management, with many increasingly convinced that, on average, actively-managed funds underperform (and will continue to underperform) passively-managed funds, once fees are taken into account. In an actively managed mutual fund, an investment manager selects individual securities which she believes will perform well. Actively-managed funds garner higher fees to pay for the research that informs the manager's investment decisions, as well as for the higher transaction costs incurred by actively managed funds that trade more frequently. Passive investments (i.e. index funds) do not require the manager to research and decide which securities to include in the portfolio – the fund simply attempts to track the index as closely and efficiently as possible. As a result, fees for index-tracking funds are generally much lower.

Plaintiffs cite research by Malkiel[i] and Jones[j] to argue that in the large-cap space, it is difficult (if not impossible) to accurately predict which investment managers will persistently outperform in the future. If, in an efficient market such as large-cap equities, manager performance is random and unpredictable, then once one accounts for management fees, index-tracking funds should on average outperform actively-managed funds. Plaintiffs argue that participants paid unnecessary fees compared to low-cost index funds, or worse, paid unnecessary fees for actively-managed funds that *under*performed the index funds (even before fees).

Failure to Remove Persistently Underperforming Investment Options

In May 2015 the Supreme Court unanimously held that, "A plaintiff may allege that a fiduciary breached the duty of prudence by failing to properly monitor investments and remove imprudent ones."[k] With this context in mind, plaintiffs have brought claims asserting that sponsors of retirement plans have fallen short of their fiduciary standards by retaining poorly performing funds on the menu of investment options.

"A plaintiff may allege that a fiduciary breached the duty of prudence by failing to properly monitor investments and remove imprudent ones."

In many cases, plaintiffs point to research that persistently poor performing funds tend to continue to underperform in the future.[l]

In *Vellali v. Yale*, plaintiffs compare the investment performance of the plan's real estate option with the returns of an index fund to demonstrate the significant underperformance of the actively managed real estate investment offering.[m]

In *Troudt v. Oracle*,[n] plaintiffs consider the subsequent performance of a fund, the Artisan Small Cap Value Fund, which they argue should have been removed sooner for underperformance. The plaintiffs argue that the underperformance could have been avoided, and claim that the failure to remove it sooner cost participants over $70 million in losses over 5 years.[o]

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[i] Burton G. Malkiel, *Returns from Investing in Equity Mutual Funds 1971 to 1991*, Journal of Finance, Volume 50, Issue 2 (June 1995) (http://indeksirahastot.fi/resource/malkiel.pdf)

[j] Robert C. Jones, *The Active Versus Passive Debate: Perspectives of an Active Quant*, Active Equity Portfolio Management, (Frank J. Fabozzi ed., 1998)

[k] https://www.supremecourt.gov/opinions/14pdf/13-550_97be.pdf

[l] Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57, 57, 59 (1997)

[m] *Vellali v. Yale* (Case number 3:16-cv-01345); complaint at page 49

[n] Case number 1:16-cv-00175

[o] The plaintiffs use a certain small-cap index fund as an alternative in their analysis; the complaint also classifies relative underperformance as "losses."

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Sponsor Self-Dealing

In complaints against financial services companies, plan participants have contended that plan sponsors ran their retirement plans for their own benefit, rather than for their employees' benefit, particularly when deciding on which funds to offer.

According to ERISA, fiduciaries are to administer employee retirement plans for the sole benefit of participants – and not for the purpose of funneling investor assets to its own funds. The retention, thus, of persistently underperforming funds can be particularly thorny for plan sponsors that are also asset management firms, with their objectivity being called into question, to the extent they retain their own underperforming funds on the plan menu while discarding underperforming funds from external investment management companies.

This potential for a conflict of interest is at the heart of complaints against asset managers, in cases such as *Bilewicz v. FMR*[p] (Fidelity). The Fidelity matter, which has settled, noted that to avoid the apparent conflict, Fidelity's competitor TD Ameritrade outsources the administration of its 401(k) plan, instead of running the plan itself.

Putnam Investments faces similar allegations of administering its employee retirement plan with a focus on its own fortunes.[q] Putnam stands accused of including on the menu proprietary mutual funds that had "little or no track record." The plaintiffs posit that Putnam uses the retirement plan to "provide seed money for these funds."

A recent *Wall Street Journal* article highlighted academic research detailing the conflict of interest phenomenon in 401(k) plans:

> *"New academic research shows that mutual-fund companies tend to favor their own funds when setting the menus for the 401(k) plans they administer. And, more important, they tend to keep those funds on the menu even when the funds are underperforming."*[r]

Separate to the issue of self-dealing, the need to monitor and remove under-performing funds extends, according to several plaintiffs, beyond those plan sponsors which also have asset-management divisions: all plans selecting asset management firms to administer their plans may be required, as fiduciaries, to ensure their plans are being administered for the benefit of its participants.

Company Stock Investment Plans

Many publicly-traded companies offer their employees the option to invest some of their 401(k) contributions in company stock. Here, too, plaintiffs argue that certain improprieties have occurred.

In *Abbott v. Lockheed Martin,* plaintiffs explain that participants' exposure to Lockheed Martin stock is indirect, via the "Company Common Stock Fund" (which holds Lockheed Martin stock and some cash) and that Lockheed Martin's matching contributions were made via this Common Stock Fund. They argue that they pay excessive fees and expenses on the investments in the Company Common Stock Fund.

A risk for employees investing in their employers' stock is that they are then doubly exposed to the fortunes of the company. If the company experiences financial difficulties, employees could be hurt both by losing their jobs and by suffering significant investment losses in their retirement accounts. Certain plaintiffs argue that it is imprudent to allow employees to *bet the house*, too heavily exposing themselves and tying their fortunes to the future performance of their own employers.

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[p] Case number 1:13-cv-10636

[q] *Brotherston v Putnam Investments, LLC;* case number 1:15-cv-13825

[r] http://www.wsj.com/articles/do-401-k-providers-favor-their-own-funds-1467684697

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Other Cases

Haddock v Nationwide Life Insurance Co.,[s] a case brought in 2001 which settled last year for $140 million, alleged that Nationwide Life Insurance Co. had received undisclosed revenue sharing payments from third-party mutual funds. The case was brought by trustees of five retirement plans that had contracted with Nationwide, a large service provider that offers retirement plans on behalf of plan sponsors.

In *Ellis v. Fidelity*,[t] employees of Barnes & Noble brought claims against Fidelity, alleging that the investment manager has mismanaged the retirement plan's Stable Value Fund by being too conservative with the fund's asset selection and by paying too much to insurers for the fund's guarantees.[u] The case is ongoing.

Dismissals

In a recent ruling (August 2016) in *White v. Chevron Corporation*,[v] Judge Phyllis J. Hamilton granted Chevron's motion to dismiss the case in its entirety, concluding "…facts as pled do not raise a plausible inference that defendants breached their fiduciary duties and/or duties of loyalty and prudence." The claims were dismissed without prejudice, allowing the plaintiffs to amend their complaint. The plaintiffs' complaint, filed in February 2016, made similar arguments to those made in many of the other complaints against retirement plan sponsors. *Investment News* characterized the decision as "a rebuke to several recurring arguments they've made in such litigation, according to fiduciary experts who follow these cases."[w]

[s] Case number 3:01-cv-01552

[t] Case number 1:15-cv-14128

[u] Stable value funds are retail investment vehicles, offered in some retirement plans, which provide a guaranteed minimum return (achieved via wrapped, i.e. guaranteed, bonds).

[v] Case number 4:16-cv-00793

[w] http://www.investmentnews.com/article/20160902/FREE/160909988/chevron-401-k-suit-dismissal-seen-as-big-loss-for-plaintiffs-bar

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Addendum - Settlements

Defendant	Case	Settlement
Ameriprise	*Krueger v Ameriprise*	$ 27,500,000
Bechtel	*Kanawi v Bechtel Corp.*	$ 18,500,000
Boeing	*Spano v The Boeing Company*	$ 57,000,000
Caterpillar	*Martin v Caterpillar Inc.*	$ 16,500,000
Cigna	*Nolte v Cigna Corp.*	$ 35,000,000
Fidelity	*Bilewicz v FMR LLC; Yeaw v FMR LLC*	$ 12,000,000
General Dynamics	*Will v General Dynamics*	$ 15,000,000
International Paper	*Beesley v International Paper Company*	$ 30,000,000
Kraft Foods	*George v Kraft Foods Global Inc.*	$ 9,500,000
Lockheed Martin	*Abbott v Lockheed Martin Corp.*	$ 62,000,000
Mass Mutual	*Gordan v Mass. Mutual Life Ins. Co.*	$ 31,000,000
Novant Health	*Kruger v Novant Health, Inc.*	$ 32,000,000
Transamerica	*Dennard et al v. Transamerica Corp.*	$ 3,800,000
Wal-Mart	*Braden v Wal-Mart Stores Inc.*	$ 13,500,000
	Total	**$ 363,300,000**

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