Northwestern University's Alternative Explanations Not Strong Enough To Defeat ERISA Excessive Fee Claims

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On remand from the U.S. Supreme Court, the Seventh Circuit issued its opinion in *Hughes v. Northwestern University*, concluding that participants in two Northwestern 403(b) plans plausibly pled fiduciary-breach claims based on allegations of excessive recordkeeping and investment management fees, but dismissed their claim that too many investment options caused them "decision paralysis." In so ruling, the Seventh Circuit applied a pleading standard that could increase the likelihood that such run-of-the-mill claims survive dismissal. As discussed below, the Seventh Circuit's ruling appears to be an unfortunate development for plan sponsors and fiduciaries and arguably stands in stark contrast to the recent trend of circuit court opinions dismissing many of these claims.

Background

In January 2022, we reported here on the Supreme Court's decision in *Hughes v. Northwestern University*, 142 S. Ct. 737 (2022) and observed that the decision was a disappointment to many in the ERISA community because it failed to provide concrete guidance to the lower courts on the pleading standard applicable to fiduciary-breach claims predicated on excessive recordkeeping and investment management fees. Instead, the Court simply held that the Seventh Circuit erred insofar as it found that the availability of a menu including investment options with lower fees was a sufficient basis to warrant dismissal of plaintiffs' excessive fee claims. The Supreme Court determined that the Seventh Circuit's rationale was inconsistent with *Tibble v. Edison Int'l,* 575 U.S. 523 (2015), which demands that plan fiduciaries monitor each investment option to ensure that it is prudent and remove imprudent funds within a reasonable time. The Court remanded the case to the Seventh Circuit with instructions to follow the requirements of *Tibble* and apply the pleading standards of *Bell Atlantic v. Twombly*, 550 U.S. 544 (2007) and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009). The Court also reiterated its views from *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409 (2014): "Because the content of the duty of prudence turns on 'the circumstances . . . prevailing' at the time the fiduciary acts, § 1104(a)(1)(B), the appropriate inquiry will necessarily be context specific. At times, the circumstances facing an ERISA fiduciary will implicate difficult tradeoffs, and courts must give due regard to the range of reasonable judgments a fiduciary may make based on her experience and expertise."

Subsequent to *Hughes*, the Sixth, Seventh, and Eighth Circuits have largely affirmed dismissal of excessive fee claims (as discussed here). In general, these courts required that plaintiffs plead specific facts about the fees and performance of the challenged investments and recordkeeping fees, so as to allow for a contextual evaluation of whether the allegations give rise to an inference of imprudence. For example:

- The Sixth Circuit held that a claim based on the use of actively managed funds in lieu of passively managed funds could not survive dismissal because common sense and the strength of defendants' competing explanations rendered the claim implausible. It also found implausible plaintiff's excessive recordkeeping fees claim because plaintiffs failed to allege that services provided to the defendants' plan were equivalent to the services of alleged comparator plans.
- The Seventh Circuit rejected an excessive recordkeeping fees claim—where the alleged fees were two to three times as much as plaintiff alleged they should be—because the complaint was devoid of any allegations as to the quality or type

of recordkeeping services provided by the alleged comparator plans.

- The Eighth Circuit rejected claims of excessive recordkeeping and investment management fees where plaintiffs simply relied on industry-wide averages because such averages were not informative and failed to provide a meaningful benchmark.

These rulings proved especially damaging to copycat complaints devoid of plan-specific details about the targeted service providers. District courts in these circuits and elsewhere subsequently dismissed excessive fee cases at a much higher rate.

The one notable exception has been the so-called “share-class” claim. In some cases, plaintiffs contend that defendants imprudently offered the retail share class of a mutual fund with higher fees when they could have offered the institutional share class of the exact same mutual fund with lower fees. Even though there is an obvious explanation for doing so—namely, that revenue sharing arrangements may rebate a portion of the fees to plan participants, thus making the retail share class effectively cheaper than the institutional share class—courts have been reluctant to dismiss this type of claim at the pleading stage. For example, the Sixth Circuit determined that plaintiffs’ share-class claim could survive dismissal because, “taken in their most flattering light,” plaintiffs plausibly pled allegations that the exact same investment was available in a cheaper share class and while “equally reasonable inferences” could exonerate defendants, it was not appropriate to resolve this issue at the pleading stage.

The Seventh Circuit’s Decision on Remand

On remand, the Seventh Circuit reconsidered the viability of claims as to whether Northwestern (1) incurred excessive recordkeeping fees, (2) used more expensive retail share classes when less expensive, identical institutional share classes were available, and (3) retained duplicative investment options. The Seventh Circuit reaffirmed, without discussion, the dismissal of plaintiffs’ prohibited transaction claims and demand for a jury trial because they had not been appealed to the Supreme Court.

Impact of Supreme Court’s Ruling on Prior Precedent

As a preliminary matter, the Seventh Circuit considered whether, and the extent to which, the Supreme Court's opinion impacted its prior decisions in *Loomis v. Exelon Corp.*, 658 F.3d 667 (7th Cir. 2011) and *Hecker v. Deere & Co.*, 556 F.3d 575 (7th Cir. 2009). On the one hand, the Seventh Circuit recognized that the Supreme Court "abrogated a line of reasoning derived from" its prior rulings that a share-class claim was not plausible if the plan offered a range of investment options, including plaintiffs' preferred type of low-cost investments. On the other hand, the Seventh Circuit concluded that three principles from *Loomis* and *Hecker* remain undisturbed: the use of revenue sharing for plan expenses does not amount to a *per se* violation of ERISA; nothing in ERISA requires plan fiduciaries to scour the market for the cheapest investment options or the cheapest recordkeeping fees, or to "constantly solicit quotes for recordkeeping services" to comply with their fiduciary duty of prudence; and plan fiduciaries may offer a wide range of investment options and fees without breaching their fiduciary duties.

Pleading Standard

The Seventh Circuit next considered the applicable pleading standard, observing that the Supreme Court's opinion provided guidance but stopped short of pronouncing a concrete standard.

The Seventh Circuit first rejected defendants' contention that *Dudenhoeffer* required plaintiffs to plead facts that an alternative prudent action that the fiduciary should have taken was "actually available" and rule out defendants' reasonable explanations for the failure to take that action. In so ruling, the court characterized *Dudenhoeffer's* pleading standard as a "heightened" pleading standard and determined that it should not be applied outside the context of an employee stock ownership plan. As discussed below, the Seventh Circuit's conclusion is difficult to reconcile with the fact that the Supreme Court expressly rejected the idea that a heightened pleading standard exists for any ERISA breach of fiduciary duty claims. In any event, the fact that the Seventh Circuit declined to rely on *Dudenhoeffer* may ultimately prove to be a distinction without a difference.

Turning to the pleading standard of *Iqbal* and *Twombly*, the Seventh Circuit explained the application of that pleading standard in the context of a breach of fiduciary duty claim as follows: A plaintiff need not rule out non-obvious explanations for defendant's allegedly imprudent conduct. Where a defendant offers an "obvious alternative explanation" for a fiduciary's conduct that would be prudent, "something more" is necessary for a complaint to survive dismissal. But that "something more" is satisfied if a plaintiff can provide a plausible showing that such alternative explanations may not account for defendant's conduct. Furthermore, although dismissal is warranted if an allegedly prudent course of action was unavailable, if the course of action was only "possibly unavailable" then dismissal would not be appropriate. Finally, the court explained that courts should "not hesitate" to dismiss the claim if a fiduciary's conduct is "patently" more reasonable and better supported by the facts. The court did not explain how defendants would show such facts at the motion to dismiss stage and what it means to be "more reasonable."

Evaluation of Plaintiffs' Claims

Applying these principles to the case at hand, the Seventh Circuit concluded that plaintiffs plausibly pled fiduciary-breach claims based on allegations of excessive recordkeeping and investment management fees. But it again dismissed the claim of fiduciary breach that was based on Northwestern having offered too many investment options.

With respect to the excessive recordkeeping claim, the Seventh Circuit found the following allegations sufficient to withstand a motion to dismiss: (i) the plans' recordkeeping fees were four to five times higher than the fees of plaintiffs' comparator plans, which allegedly should have been no more than $35 per participant; and (ii) other universities had recently consolidated recordkeepers, switched pricing models, and negotiated down recordkeeping fees. The court rejected Northwestern's alternative explanations, including that it could not consolidate its recordkeepers because one of them, TIAA, would not allow other recordkeepers to administer its products, because plaintiffs alleged that other universities had consolidated to one non-TIAA recordkeeper while still retaining the TIAA products. At bottom, the court determined that Northwestern's alternative explanations were not "strong enough" to justify dismissal of plaintiffs' excessive recordkeeping fee claim.

In so ruling, the court distinguished, and seemingly provided plaintiffs an easy way to sidestep, its previous decision in *Albert v. Oshkosh*, 47 F.4th 570 (7th Cir. 2022). The court explained that, whereas the *Albert* plaintiff failed to provide allegations as to the quality or type of recordkeeping services the allegedly cheaper comparator plans provided, the *Hughes* plaintiffs specifically alleged that the recordkeeping services are commoditized, there are numerous recordkeepers equally capable of providing such services, and that these recordkeepers will aggressively bid to offer the best price in an effort to win business.

Turning next to the claim that Northwestern imprudently retained higher fee share classes of investment options despite the availability of lower fee share classes, the Seventh Circuit was in the first instance influenced by the “similarity” between the share-class claims asserted in *Tibble*, which survived dismissal, and the share-class claims asserted by plaintiffs in *Hughes*. The Seventh Circuit then rejected Northwestern’s alternative explanation that it could not have invested in the cheaper institutional share classes because the plan did not satisfy the threshold investment requirements, finding that plaintiffs plausibly alleged that waivers of investment minimums were possible and provided an example of another plan that obtained such a waiver. The court also rejected Northwestern’s “obvious explanation” that the higher fee share classes provided revenue sharing that was rebated to the plans and helped defray the overall recordkeeping fees because this explanation was not “so much more obvious” than plaintiffs’ explanation, particularly since plaintiffs alleged that the plans collectively paid about four to five times more for recordkeeping fees than other plans.

Finally, the Seventh Circuit affirmed dismissal of the claim that offering too many or duplicative investment options caused participants decision paralysis or confusion because plaintiffs did not identify how they were confused or what injury they suffered.

Proskauer’s Perspective

The Seventh Circuit's decision may prove to be an unfortunate development for plan sponsors and fiduciaries, particularly if other circuits follow suit. As discussed above, the decision appears to reverse what previously appeared to have been a trend favoring tighter controls on excessive fee litigations at the pleading stage, and to possibly suggest that, through more careful and specific pleading, plaintiffs can overcome any obstacles to proceeding to discovery with their claims. Particularly disturbing is the fact that although the Seventh Circuit left plaintiffs with the burden to overcome obvious explanations, it allows plaintiffs to defeat such obvious alternative explanations by merely proffering other potentially plausible explanations. As an example of this standard's weakness, it is difficult to imagine a more obvious alternative explanation for offering retail share classes of mutual funds than the benefits of revenue sharing that pays for recordkeeping fees, which are not offered by institutional share classes, but the Seventh Circuit was not moved by this obvious explanation.

Tempering these concerns somewhat is the fact that the same circuit that rendered this decision also dismissed recordkeeping claims in *Albert v. Oshkosh*, in which plaintiff brought excessive recordkeeping fee claims where the plan allegedly paid $87 per participant and invested in allegedly expensive and poorly performing funds. In purporting to distinguish *Albert*, the court seized on a number of facts and circumstances unique to this case, including a more significant recordkeeping fee disparity and that the alternative explanations proffered by defendants were specifically refuted by the pleadings. That being said, the court essentially credited allegations that could be (and have been) made in every case and, if followed by other circuits, could provide the plaintiffs' bar with a roadmap on how to plead dismissal-proof excessive recordkeeping fee claims in the future.

Our reading of the Seventh Circuit's decision in *Hughes*, particularly in the wake of *Albert* and some of the dismissals in other jurisdictions, leaves us with the impression that we will continue to see seemingly irreconcilable rulings until there is further clarity from the Supreme Court.

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