Morgan Stanley

What Plan Sponsors Can Learn from Recent 401(k) Plan Litigation

Introduction

The landscape of retirement planning is constantly evolving, and one area that has seen significant growth in recent years is 401(k) plan litigation. These lawsuits, which often center around fiduciary issues such as excessive fees paid to third party service providers, poorly performing investment options, and other breaches of ERISA fiduciary duties of loyalty and prudence, have the potential to significantly impact both plan sponsors and participants.

The rise in 401(k) plan litigation underscores the increasing scrutiny placed on plan sponsors when satisfying their fiduciary duties. As the stewards of their employees' retirement savings subject to the high standards of ERISA, sponsors are expected to act prudently and loyally in the sole interests of their participants. This includes ensuring that the plan's fees are reasonable under the circumstances, its investment options are appropriate, and its operations and administration follow a prudent process. Failure to meet these standards can result in costly lawsuits, damaging not only a company's finances but also its reputation.

For plan sponsors, staying informed about these legal developments is not just a matter of good business practice, but arguably a responsibility so to inform fiduciary decision-making. This article will highlight some recent cases, outcomes, and suggested best practices for plan sponsors to consider as a result.

Fee Litigation

Employers, retirement plan committees, and other plan fiduciaries continue to face lawsuits by plaintiffs alleging the fiduciaries breached their duties under ERISA by allowing their 401(k) plans to pay excessive investment and administrative fees.

- In the recent case of *Lauderdale v. NFP Retirement, Inc. et al.,* plaintiffs brought a class action lawsuit against their employer and the advisor hired to manage target date funds (“TDFs”), alleging defendants breached their fiduciary duties under ERISA by imprudently selecting and failing to remove certain TDFs from the investment plan lineup, as well as for engaging in certain prohibited transactions. The court sided with the defendant and advisor in granting summary judgment in their favor, citing robust processes used to assess participant data and compare TDFs to determine which would best fit participant demographics and investment preferences, among other factors evidencing a prudent fiduciary approach (including by monitoring investment structure, design and performance, and also by attempting to negotiate fees).

- Another example of fee litigation is *Falberg v. Goldman Sachs Group, Inc.,* whereby plaintiffs appealed a district court's prior grant of summary judgment in favor of the plan sponsor, plan committee, and committee members, and alleged defendants gave preferential treatment to proprietary mutual funds. In finding that the defendants did not breach their duty of loyalty, the court emphasized the robust process that the defendants used to manage potential conflicts of interest, including requiring fiduciaries to participate in training sessions and using independent advisors to provide unbiased advice. Additionally, in finding that the defendants did not breach their duty of prudence, the court recognized the defendant's deliberative process for selecting and monitoring investments, including that the committee members were experienced financial professionals supported by experts, who held meetings and examined performance reports on a monthly and quarterly basis.

These decisions highlight the importance of plan fiduciaries exercising "procedural prudence," meaning courts will look to the actions taken and processes utilized to reach a decision rather than strictly at the results. Courts will use individual facts to determine whether a fiduciary's actions were prudent, and the defendants in these cases prevailed because they were able to point to documentation of their prudent process for monitoring and managing plan investments.

Plan sponsors and plan fiduciaries may consider the following:

- Establishing, maintaining, and periodically reviewing formal, clearly documented processes utilized by plan fiduciaries when making investment related decisions for the plan.
- Adopting a methodology for qualified default investment alternative ("QDIA") selection that helps to ensure appropriateness for the participant base.
    - For example, a QDIA with an intentionally aggressive asset allocation with greater exposure to high-growth asset classes may appear to deliver superior results to a fund that seeks a balanced asset allocation, however what looks like superior returns may be simply reflective more exposure to market risk.
- Documenting a plan fiduciary's reasonable actions in its selection of an investment option under the circumstances facing the fiduciary at the time of such investment decision in such processes to demonstrate both procedural prudence and the basis for each investment decision.

ESG Litigation

Given the public attention to environmental, social and governance ("ESG") investments, plaintiffs continue to target plans utilizing ESG investments and investment strategies. A recent court decision in Spence v. American Airlines, Inc. highlights that proxy voting decisions can, in some circumstances, lend support to fiduciary breach allegations.

In June 2023, a class of American Airlines employees filed suit against the employer challenging the consideration of ESG factors when managing and making plan investments. Specifically, the plaintiffs alleged that the defendants violated their fiduciary duties by knowingly investing, and continuing investments of, the 401(k) plan in funds with investment managers who utilize ESG policies or that otherwise pursue ESG policy goals. The plaintiffs focused on BlackRock and its "focus on socio-political outcomes instead of exclusively on financial returns."

The defendants moved to dismiss the case claiming that, among other things, the plaintiffs had not claimed sufficient facts to establish that the consideration of ESG factors impacted fund performance. The court denied this motion, holding that it was sufficient for plaintiffs to base their claims on general reporting on the underperformance of ESG funds and the defendants alleged failure to consider the circumstances in which the manager had cast proxy votes that resulted in a decline in value. In response to the denial of its motion to dismiss the suit, American Airlines filed a motion for summary judgment in February 2024; however, in June 2024, the court denied this motion and permitted the case to go to trial. Depending on the outcome at trial, plan sponsors may be vulnerable to future challenges by plaintiffs for not seeking to prevent even short-term dips in stock prices, which plaintiffs may claim are traceable in some way to shareholder vote outcomes in connection with purported ESG "activism".

Plan sponsors and plan fiduciaries may consider the following:

- Reviewing the plan document, investment policy statement (if any) and other investment parameters to determine whether it permits the consideration of any ESG factors in plan fiduciary investment-related decisions, including the exercise of shareholder rights such as proxy voting.
- Think about how ESG-based strategies may affect the performance of the investment and how best to weigh these factors based on the overall financial impact of the investment.
- Consider including language expressly permitting a plan fiduciary to consider ESG factors in plan investment decisions, where appropriate and subject to the plan fiduciary's satisfaction of their fiduciary duties under ERISA and the evaluation of a plan's investment option is focused on factors (both economic and non-economic) that the fiduciary reasonably determines are relevant to a risk-return analysis.
- Given the public attention to ESG, retirement plan fiduciaries should ensure they understand their fiduciary duties and risks, particularly surrounding the consideration of ESG factors in plan investment performance, decisions, and strategies.

Conclusion

In conclusion, the landscape of 401(k) plan litigation is complex and ever evolving. The stakes are high for plan sponsors, as they bear the fiduciary responsibility for the retirement savings of their employees. The potential for costly lawsuits, regulatory penalties, and reputational damage makes it imperative for plan sponsors to stay informed and proactive in managing their 401(k) plans.

However, navigating the intricacies of 401(k) plan litigation can be daunting for even the most seasoned plan sponsors. A legal professional with experience in 401(k) plan litigation can provide guidance on best practices, help identify potential areas of vulnerability, and assist in developing strategies to mitigate risk.

In the end, the goal is not just to avoid litigation, but to provide a robust and effective 401(k) plan that serves the retirement needs of employees. By staying informed and proactive, and by seeking the guidance of an experienced ERISA lawyer, plan sponsors can achieve this goal and help safeguard the financial future of both the plan's participants and the sponsoring organization.

Disclosures

When Morgan Stanley Smith Barney LLC, its affiliates and Morgan Stanley Financial Advisors and Private Wealth Advisors (collectively, "Morgan Stanley") provide "investment advice" regarding a retirement or welfare benefit plan account, an individual retirement account or a Coverdell education savings account ("Retirement Account"), Morgan Stanley is a "fiduciary" as those terms are defined under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and/or the Internal Revenue Code of 1986 (the "Code"), as applicable. When Morgan Stanley provides investment education, takes orders on an unsolicited basis or otherwise does not provide "investment advice", Morgan Stanley will not be considered a "fiduciary" under ERISA and/or the Code. For more information regarding Morgan Stanley's role with respect to a Retirement Account, please visit www.morganstanley.com/disclosures/dol. Tax laws are complex and subject to change. Morgan Stanley does not provide tax or legal advice. Individuals are encouraged to consult their tax and legal advisors (a) before establishing a Retirement Account, and (b) regarding any potential tax, ERISA and related consequences of any investments or other transactions made with respect to a Retirement Account.

October 2024; Groom Law Firm, Washington, DC (Home - Groom Law Group) Groom Law Group is a Washington, DC-based law firm specializing in benefits, retirement, and health care law. Groom is consistently ranked as a top-tier law firm which solves complex legal challenges for clients in finance, retirement, health care, and the public sector. This has been prepared in consultation with Groom and sourced from materials provided to Morgan Stanley by Groom. The views, opinions or advice contained within this are solely those of the author and do not necessarily reflect those of Morgan Stanley Smith Barney LLC or its affiliates. The strategies and/or investments referenced may not be appropriate for all investors as the appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Morgan Stanley is not responsible for the information herein nor do we guarantee their accuracy and completeness. This is intended to be a summary only and necessarily does not cover every nuance, fact or circumstance. This presentation is not intended to provide and shall not directly or indirectly constitute nor be relied upon as, legal or fiduciary advice, and contains only educational information. Plan sponsors should consult their own experienced ERISA legal counsel in connection with all plan legal matters. Because this content is copyrighted, you cannot share, disseminate, publish, or otherwise reproduce it without permission.

CRC 3995602 11/2024