Sweda v. University of Pennsylvania: Give and Take from the Third Circuit

Employee Benefits Alert
05.06.2019

On May 2, 2019, the Third Circuit issued its precedential decision in *Sweda v. University of Pennsylvania*, the first appellate decision to address the recent wave of ERISA lawsuits filed against several elite private universities alleging the mismanagement of their defined contribution plans (University fees cases).[1] In a mixed result for the University of Pennsylvania (Penn), the circuit court, in a 2-1 split decision, affirmed dismissal of the prohibited transaction claims, but reinstated the core prudence claims, remanding them to the district court for further proceedings. The result creates a circuit split on the scope of ERISA with respect to party-in-interest transactions, diverges from other circuit courts by permitting greater leniency in determining the plausibility of plaintiff-participants' allegations of fiduciary misconduct at the motion-to-dismiss stage, and appears to retreat from the Third Circuit's own prior precedent in deciding issues of excessive fees. Looking ahead, the Third Circuit's views are applicable beyond the University fees cases to the broader realm of ERISA class action litigation and could further encourage suits against plan sponsors and fiduciaries.

Background

Penn's employee retirement plan, the university equivalent of a corporate 401(k) plan, had two recordkeepers, offered 78 investment options, the majority of which were mutual funds, and held close to $4 billion in assets. Mirroring many of the allegations made in the 20 or so suits filed in the University fees cases, the *Sweda* complaint claimed fiduciary breach and prohibited transactions in connection with the management of the Penn plan. The plaintiffs alleged that the plan fiduciaries breached their ERISA duties by failing to properly manage the plan's investments – for example, not replacing poorly performing funds, including retail funds when identical institutional funds with lower fees were available, retaining multiple duplicative funds – and overpaying the plan's recordkeepers by up to 600 percent.[2]

Three claims asserted that the fiduciaries breached ERISA's duties of prudence and loyalty, three additional claims sought relief for alleged party-in-interest prohibited transactions (the plaintiffs did not allege any self-dealing violations), and Claim VII asserted a failure to monitor the appointed fiduciaries. The district court dismissed all seven claims, finding that the plaintiffs failed to state a claim for relief under the Supreme Court's *Twombly*[3] pleading standards and the Third Circuit's earlier decision, *Renfro v. Unisys Corp.*, because the allegations were not plausible and were indicative of reasonable conduct.[4]

Dismissal of Party-in-Interest Prohibited Transaction Claims

On appeal, the Third Circuit affirmed the dismissal of one of the prudence claims as time-barred. Agreeing also that the prohibited transaction claims were properly dismissed, the Third Circuit first determined that ERISA's prohibitions against party-in-interest transactions, set forth in ERISA § 406(a), were intended to prevent "transactions deemed likely to injure . . . the plan" and "self-dealing."[5] The court then "decline[d]" to read § 406(a) as "prohibit[ing] ubiquitous service transactions and requir[ing] a fiduciary to plead reasonableness as an affirmative defense" in the absence of any allegations of self-dealing or a specific intent to benefit the party in interest.[6] By doing so, the Third Circuit recognized that it was in express disagreement with the Seventh Circuit, which had held that § 406(a) creates a per se rule against party-in-interest transactions and requires an exemption pled as an affirmative defense by defendants.[7]

In the Third Circuit's view, the determination that "every furnishing of goods or services between a party and a party in interest is a prohibited transaction under [§ 406(a)]" swept too broadly and portended unreasonable litigation risk to service providers.[8] Therefore, when applied to "ordinary service arrangements" or "ordinary recordkeeping arrangements," the court held that plaintiffs must provide "factual allegations that support an element of intent to benefit a party in interest" to plausibly state a claim under §

406(a).[9] Because the *Sweda* plaintiffs did not include such allegations, the Third Circuit upheld the dismissal of their § 406(a) claims.

Survival of Prudence and Loyalty Claims

Two fiduciary breach claims remained for review. The Third Circuit, noting that the claims had been dismissed "at the earliest stage in litigation,"[10] reversed their dismissal and remanded both to the district court for further proceedings. Its first step was to examine the pleadings standards for ERISA claims. Disagreeing with most of its sister circuit courts that have addressed such claims and arguably breaking with its own precedent, the Third Circuit concluded that the pleading standards stated in *Twombly* and *Renfro* – which it had previously applied as requiring dismissal where "actions that are at least just as much in line with a wide swath of rational competitive business strategy in the market as they are with a fiduciary breach" – should not apply to fiduciary breach claims under ERISA.[11] The Third Circuit examined at length the protective purposes of ERISA and reasoned that requiring plaintiff-participants "to rule out every possible lawful explanation" for the challenged conduct was inconsistent with the federal rules governing motions to dismiss and the Congress' intent to safeguard plan management and operations.[12]

Significantly, in applying these new principles to the *Sweda* claims, the court acknowledged the importance of fiduciary process in reviewing a fiduciary's conduct. Thus, reviewing allegations of fiduciary breach requires "asking whether the fiduciary employed the appropriate methods to investigate and determine the merits of a particular investment."[13] Previewing its decision to reverse dismissal of the fiduciary breach claims, the Third Circuit remarked that "[m]any allegations concerning fiduciary conduct, such as reasonableness of compensation for services[,] are inherently factual questions for which neither ERISA nor the Department of Labor give specific guidance."[14] These matters, because they relate to the merits, should not be decided at the early, pleadings stage.[15]

Turning to *Sweda*'s two fiduciary breach claims, the court concluded that the allegations plausibly stated a claim for relief. The "numerous and specific factual allegations" recited that Penn paid excessive administrative fees, failed to solicit service provider bids, did not monitor revenue sharing, did not negotiate for lower fees or rebates, paid unreasonable investment fees, retained expensive and poorly performing investment options, and retained multiple investment funds with the same asset class and investment style.[16] In addition, the plaintiffs offered specific comparisons of investment returns and described conduct of "similarly situated fiduciaries" to show what objectively prudent fiduciaries would do.[17] These allegations, according to the Third Circuit, provided "substantial circumstantial evidence" that supported drawing reasonable inferences that a breach had occurred at this early stage.[18]

Even so, the Third Circuit pointedly remarked that, during the merits stage of the litigation, "Penn may be able to demonstrate that its process was prudent."[19] To date, only one of the University fee cases has proceeded to trial, with the fiduciaries being fully vindicated.[20]

The Dissenting View

Concurring in the dismissal of the four claims, Senior Judge Roth dissented from the reversal of the two fiduciary breach claims and would have dismissed them as well. In his view, the majority decision encourages litigation against fiduciaries of large plans and places them "in an unenviable position, in which [they have] every incentive to settle quickly to avoid (1) expensive discovery and further motion practice, (2) potential individual liability for named fiduciaries, and (3) the prospect of damages of calculations, after lengthy litigation, with interest-inflated liability totals."[21] Further, he expressed concern that any recovery to plan participants may not be meaningful and would be diluted because "a substantial portion . . . are instead diverted to attorneys' fees."[22] The dissent believed that *Sweda* could not be distinguished from the Third Circuit's 2011 decision in *Renfro*, in which the court, reviewing the issues at the same procedural stage, "determined that the mix and range of investment options in the retirement plan provided by Unisys was sufficient to demonstrate that the defendants' fiduciary duty had been met."[23]

Considerations Going Forward

Miller & Chevalier

In light of the mixed results from the Third Circuit, plan fiduciaries and plan sponsors should keep these considerations in mind:

- A prudent fiduciary process continues to be central in litigation concerning fiduciary conduct. For example, plan fiduciaries should continue to be diligent in reviewing and monitoring investment selection and retention, remove or have a process for evaluating underperforming funds, understand and monitor plan expenses, and review service provider performance and fees, including benchmarking fees or engaging in a bid process. These efforts should be documented.
- The Third Circuit's holding that recordkeeping or "ordinary" service provider agreements are not "prohibited transactions" subject to § 406(a) and, by extension, not subject to the reasonable services and fees requirements and disclosures under the § 408(b) exemption is a minority view. The Department of Labor is not likely to forego demanding that fiduciaries and service providers of ERISA plans in the Third Circuit comply with § 408(b).
- Notwithstanding the Third Circuit's prohibited transaction analysis under § 406(a), ERISA's prudence and loyalty obligations under § 404(a) continue to adhere to the fiduciary's review and monitoring of service providers, including a determination that the services are necessary and the fees reasonable.
- Litigation targeting large plans and even mid-size plans may increase. *Sweda* is one of three recent circuit court decisions in plaintiffs' favor.[24] While these decisions may not quite signify a trend, they will likely embolden the plaintiffs' bar to continue filing similar cases.

For more information, please contact:

Theresa S. Gee, tgee@milchev.com, 202-626-5928

Elizabeth F. Drake*

Anthony G. Provenzano*

**Former Miller & Chevalier attorney*

----

[1]*Sweda v. University of Pennsylvania*, No. 17-3244, Slip Opinion (Slip Op.) (3d Cir. May 2, 2019). Appeals are pending in ERISA suits filed against Johns Hopkins University, Northwestern University, New York University, and Washington University in Saint Louis.

[2]Slip Op. at 4.

[3]*Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007) (requiring that complaint "contain sufficient factual matter, accepted as true, to state a clam to relief that is plausible on its face"); *see also Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (same).

[4]671 F.3d 314 (3d Cir. 2011) (concluding, on motion to dismiss, that offering mix and range of investment options satisfied fiduciaries' ERISA duties).

[5]Slip Op. at 29.

[6]*Id.* at 29-30, 32-33.

[7]*Allen v. GreatBanc Trust Co*., 835 F.3d 60, 676 (7th Cir. 2016) (citing to decisions by the Second, Fourth, Fifth, Eighth, and Ninth Circuits).

[8]Slip Op. at 30.

[9]*Id.* at 33-38 (affirming dismissal of 406(a) claims in absence of allegations of subjective intent to benefit party in interest).

[10] *Id.* at 7.

[11]Slip Op. at 8-9. *But see, e.g., White v. Chevron Corp*., 2018 WL 5919670 (9th Cir. Nov. 13, 2018) (affirming dismissal where plaintiffs' allegations did not negate possibility that challenged conduct could be consistent with appropriate fiduciary conduct).

[12]*Id.* at 8-10 *quoting Braden v. Wal-Mart Stores, Inc*., 588 F.3d 585, 597 (8th Cir. 2009).

Miller & Chevalier

[13] Slip Op. at 15.

[14] *Id.* (internal quotations omitted) *quoting* DOL Advisory Opinion 2013-03A.

[15] Slip Op. at 23.

[16] *Id.* at 18, 20.

[17] *Id.* at 20-21.

[18] *Id.* at 22.

[19] *Id.* at 23.

[20] *Sacerdote v. New York University*, 328 F. Supp. 3d 273 (S.D.N.Y. 2018) (appeal pending).

[21] Slip Op., Roth J., dissenting, at 1.

[22] *Id.* at 3, 7.

[23] *Id.* at 13.

[24] *See Jander v. Retirement Plans Committee of IBM* , 910 F.3d 620 (2d Cir. 2018) (reversing dismissal of claims that fiduciaries breached ERISA duties in retaining employer stock); *Brotherston v. Putnam Investments, LLC*, 907 F.3d 17 (1st Cir. 2018) (reversing judgment in favor of fiduciaries and holding that "once an ERISA plaintiff has shown a breach of fiduciary duty and loss to the plan, the burden shifts to the fiduciary to prove that such loss was not caused by its breach, that is to prove that the resulting investment decision was objectively prudent").
