Active management plays an important role in 401(k) plans

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Executive summary

A fundamental principle under the Employee Retirement Income Security Act of 1974 ("ERISA") is that plan fiduciaries must act as a prudent person in the best interest of the plan's participants. This principle applies to the selection of investment options for a 401(k) plan, regardless of whether the investment funds selected are actively managed or passively managed.

ERISA does not favor one type of investment strategy over another, provided that the fiduciaries act prudently in selecting and monitoring investment funds.

While plaintiffs in ERISA class action litigation have challenged active strategies as allegedly inferior to passive strategies, neither the U.S. Department of Labor ("DOL") nor the courts have opined that active strategies are inappropriate for 401(k) plans. This is not surprising, because ERISA does not mandate any type of investment as necessarily prudent or imprudent. ERISA is not "black and white" law – it is not prescriptive and there is significant flexibility in applying its requirements.

Several recent court decisions have squarely rejected plaintiffs' "apples to oranges" comparison of active strategies to passive strategies. Courts have ruled that active strategies "have different aims, different risks and different potential rewards"[1] compared to passive strategies and that plan fiduciaries acting in the best interest of plan participants – as required under ERISA – may prudently include actively managed funds in the plan's investment lineup to provide "plan participants with the opportunity to take on more risk and pay higher fees in the hope of beating the market."[2] To these courts, the academic debate over the "merits of passively managed funds versus actively managed funds" does not mean that plan fiduciaries should decide the issue for all plan participants by offering only passively managed funds in the plan's investment lineup.[3]

There is also a recognition that not all active strategies are attempting to beat the market. For example, a court gave credit to testimony that an actively managed fund was designed to have lower volatility compared to the market, such that the fund's underperformance in an up market would be nothing more than the fund – with a lower risk profile than the market – performing as expected.[4]

Looking to these considerations, ERISA does not favor one type of investment strategy over another and, provided that the fiduciaries act prudently in selecting and monitoring investment funds, including actively managed funds in a plan's investment lineup could be an effective approach to reducing the fiduciaries' potential liability.

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[1] *Davis v. Washington Univ. in St. Louis, 960 F.3d 478, 485 (8th Cir. 2020).*

[2] *Smith v. CommonSpirit Health, No. CV 20-95-DLB-EBA, 2021 WL 4097052, at *7 (E.D. Ky. Sept. 8, 2021); see also Davis v. Salesforce.com, Inc., No. 20-CV-01753-MMC, 2020 WL 5893405, at *3 (N.D. Cal. Oct. 5, 2020) (noting that "actively and passively managed funds have, for example, different management approaches" and that actively managed strategies can, among other things, provide an opportunity to earn superior returns and take advantage of alternative investment strategies).*

[3] *See, e.g., Parmer v. Land O'Lakes, Inc., 518 F. Supp. 3d 1293, 1307 (D. Minn. 2021).*

[4] *Reetz v. Lowe's Companies, Inc. No. 5:18-CV-00075, 2021 WL 4771535, at *34 (W.D.N.C. Oct. 12, 2021).*

When ERISA principles, DOL authorities and court decisions are considered, plan fiduciaries may conclude that active strategies can serve an important role in a 401(k) plan.

Introduction

When Congress enacted ERISA in 1974, passively managed funds were generally nonexistent, meaning that Congress could not have intended to disfavor actively managed funds. And as defined contribution 401(k) plans became more prevalent, active strategies have always played an important role in diversifying the plan's investment lineup and providing plan participants with an opportunity to outperform the market.

Active strategies have evolved to become an even more important component of 401(k) plans. For example, target date funds have made retirement investing easier for plan participants by providing a diversified portfolio that automatically adjusts its risk-return profile over time. This is made possible, of course, through an actively managed glide path — even if a fund itself is described as "passive" in nature.[5] Similarly, custom "white label" funds use active management to allocate assets among underlying investments, and plan participants have the opportunity to benefit from access to a diversified portfolio.

The position of some plan fiduciaries is that active strategies can be categorically excluded from a 401(k) plan lineup. This position is often reinforced by arguments made in litigation — but not actual court decisions or regulatory authority. Given that claims have been brought alleging missed investment opportunities (e.g., that a stable value fund should have been offered rather than a money market fund[6] and — potentially — vice versa), there is nothing stopping plaintiffs' firms from claiming that a per se exclusion of active funds is a fiduciary breach as well. Thus, a comprehensive and prudent investment selection process that considers a wide range of investment strategies may help protect plan fiduciaries, even if the result of such a process is that an all-active or all-passive lineup is selected for the plan.

As explained in this white paper, when ERISA principles, DOL authorities and court decisions are considered, plan fiduciaries may conclude that active strategies can serve an important role in a 401(k) plan.

[5] *For this reason, target date funds that allocate to passively managed underlying investments have become subject to underperformance claims. Cutrone v. Allstate, No. 1:20-cv-06463, (N.D. Ill. filed Oct 30, 2020); Callaway v. The Northern Trust Company, No. 1:20-cv-6467, (N.D. Ill. filed Nov. 2, 2020); Ford v. Takeda Pharmaceuticals, No. 1:21-cv-10090, (D. Mass. filed Jan. 19, 2021); Allegretti v. Walgreen Co., No. 1:19-cv-05392 (N.D. Ill. filed Dec. 1, 2020). We note that these lawsuits can be costly to resolve. For example, the defendants in the Allegretti v. Walgreen Co. litigation agreed to pay $13.75 million to settle the plaintiffs' allegations regarding the target date funds.*

[6] *Bell v. Anthem, Inc., No. 1:15-cv-2062 (S.D. Ind. filed Dec. 29, 2015) (as a condition to settlement, the plan fiduciaries agreed to consider adding a stable value fund to the plan); Pledger v. Reliance Trust Co., No. 1:15-cv-4444 (N.D. Ga. filed Dec. 22, 2015).*

If the investment strategy is to beat market returns, plan fiduciaries should know that neither DOL nor the courts have taken a position on the active versus passive debate by ruling that active management cannot beat market returns over the long term.

Plan fiduciaries must prudently select and monitor plan investment options regardless of whether the investment option uses an active or passive strategy

Fiduciaries to a 401(k) plan are responsible for prudently selecting and monitoring the investment options made available under the plan.[7] While ERISA section 404(c) provides that participants in 401(k) plans are generally responsible for the consequences of their own investment decisions, this rule applies only to the extent the plan's investment options were prudently selected (and monitored) by the plan fiduciaries.[8] Thus, ERISA section 404(c) does not absolve plan fiduciaries from their responsibility to prudently select and monitor plan investment options.[9]

The duty of prudence under ERISA requires plan fiduciaries to engage in a "reasoned decision-making process, consistent with that of a prudent man acting in a like capacity."[10] Under DOL regulations interpreting the prudent-person standard, plan fiduciaries, in making investment decisions, should give "appropriate consideration" to the relevant facts and circumstances in light of the role a "particular investment or investment course of action" plays in the "plan's investment portfolio."[11] The DOL's view is that, in determining appropriate investment options for a 401(k) plan, the "facts and circumstances relevant to an investment or investment course of action would include consideration of the expected return on alternative investments with similar risks available to the plan."[12] Under this view, comparing an active strategy to a passive strategy with a differing risk-return profile could be viewed as an inappropriate comparison.

As to what factors should be considered by plan fiduciaries, the DOL's view is that plan fiduciaries should focus on "material risk-return factors."[13] As to active strategies, plan fiduciaries should, among other factors, consider the manager's investment strategy, the level of risk the manager will take to implement the strategy, the fee charged for the strategy, and the manager's skill and performance history. If the investment strategy is to beat market returns, plan fiduciaries should know that neither DOL nor the courts have taken a position on the active versus passive debate by ruling that active management cannot beat market returns over the long term.

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[7] *Tibble v. Edison Int'l, 575 U.S. 523, 529 (2015) (noting that "a trustee has a continuing duty to monitor trust investments and remove imprudent ones" and that "this continuing duty exists separate and apart from the trustee's duty to exercise prudence in selecting investments at the outset").*

[8] *DiFelice v. U.S. Airways, Inc., 497 F.3d 410, 418 n. 3 (4th Cir. 2007) (noting that ERISA section 404(c) "does not insulate a fiduciary from liability for assembling an imprudent menu in the first instance"); see also Howell v. Motorola, Inc., 633 F.3d 552, 567 (7th Cir. 2011) (holding that "the selection of plan investment options and the decision to continue offering a particular investment vehicle are acts to which fiduciary duties attach, and that the [ERISA section 404(c) safe harbor] is not available for such acts"); In re Suntrust Banks, Inc. Erisa Litig., No. 1:08-CV-03384-RWS, 2015 WL 12734077, at *1 (N.D. Ga. Oct. 8, 2015) (observing that " numerous courts have held that § 404(c) is inapplicable to a fiduciary's selection or retention of imprudent investment options").*

[9] *Supra note 7.*

[10] *U.S. Airways, 497 F.3d at 420.*

[11] *29 C.F.R. § 2550.404a-1(b).*

[12] *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272, 57277 (proposed Oct. 14, 2021).*

[13] *Id. at 57288 (noting that "under ERISA, if a fiduciary prudently concludes climate change and other [environmental, social and governance] factors are material to an investment or investment course of action under consideration, the fiduciary can and should consider them and act accordingly, as would be the case with respect to any material risk-return factor").*

Whether plan fiduciaries acted prudently in making an investment decision cannot be measured in hindsight based on how the investment performed.

In this regard, studies show that some active managers have a long track record of beating the market after fees.[14] However, in the end, a final decision needs to be made by fiduciaries as to the weight of factors they deem important through their prudent process.

Because there is no ERISA-codified distinction between active and passive investments, the same selection and monitoring principles apply to passive strategies as well. For example, the plan fiduciaries should consider the manager's investment strategy – i.e., is the manager holding all securities represented on an index or using a sampling strategy? The plan fiduciaries should also consider whether the investment strategy involves additional risk, such as securities lending risk. Importantly, plan fiduciaries should not assume that selection and monitoring of passive strategies would only require consideration of the strategy's tracking error and fees. Each plan and its investments are unique and, as such, in some cases, additional evaluation of passive strategies may be merited.

Even if a fund were to lose money (rather than merely underperform its benchmark) over multiple years, plan fiduciaries can assert that they should not be held liable for participant losses resulting from investing in that fund as long as they acted prudently in staying with the fund. This position was confirmed in a court decision involving investment funds in a 401(k) plan that sustained losses over a three-year period.[15] The court noted that, when selecting the funds, the fiduciary had considered their long-term prospects and regularly monitored their performance.[16] The court thus confirmed that the funds' investment losses alone did not establish a breach of fiduciary duty.[17] Many other courts have ruled that whether plan fiduciaries acted prudently in making an investment decision cannot be measured in hindsight based on how the investment performed.[18]

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[14] *See, e.g., Antti Petajisto, "Active Share and Mutual Fund Performance," January 15, 2013 (http://papers.ssrn.com/sol3/papers.cfm? abstract_id=1685942); Cremers, Ferreira, Matos, Starks, "Indexing and Active Fund Management: International Evidence," Journal of Financial Economics, February 1, 2015, p. 27.*

[15] *Jenkins, 444 F.3d at 926.*

[16] *Id.*

[17] *Id.*

[18] *U.S. Airways, Inc., 497 F.3d at 424 ("First and foremost, whether a fiduciary's actions are prudent cannot be measured in hindsight . . . ."); Chao v. Merino, 425 F.3d 174, 182 (2d Cir. 2006) (plan fiduciary's "actions are not to be judged from the vantage point of hindsight"); DeBruyne v. Equitable Life Assur. Soc. of the U.S., 920 F.2d 457, 465 (7th Cir. 1990) ("The ultimate outcome of an investment is not proof of imprudence."); Jenkins v. Yager, 444 F.3d 916, 926 (7th Cir. 2006) ("We have stated that investment losses are not proof that [a fiduciary] violated his duty of care."); Bussian v. RJR Nabisco Inc., 223 F.3d 286, 299 (5th Cir. 2000) ("ERISA's test of prudence is one of conduct, and not a test of performance of the investment."); Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir. 1983) ("The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investment succeeded or failed.").*

Fiduciaries should keep in mind: ERISA does not limit the type of investment strategy that can be used for plan investments and the DOL is neutral on active vs. passive management.

The importance of process – and not just performance or fees – is also highlighted in other forms of investments. For example, plaintiffs in a case involving US Airways' 401(k) plan challenged the decision of plan fiduciaries to retain an employer stock fund as an investment option until US Airways filed for bankruptcy.[19] Although the court noted that the employer stock fund was exempt from the diversification requirements of ERISA, it analyzed the prudence of the decision to retain the fund as it would any investment, including whether fiduciaries "employed the appropriate methods to investigate the merits of the investment."[20] The court then held that the plan fiduciaries acted prudently by regularly meeting to discuss the status of the stock fund and by seeking independent advice.[21] The court explained that, although the stock fund ultimately lost its value through bankruptcy, the decision of an ERISA fiduciary "cannot be measured in hindsight" and an investment's diminution in value does not alone establish a breach of fiduciary duty.[22]

ERISA does not mandate any type of investment as necessarily prudent or imprudent

While ERISA is a "comprehensive and reticulated statute,"[23] it does not mandate specific investments or investment types as necessarily prudent or imprudent. There are certain specific rules, such as the prohibition on the extent to which a defined benefit plan can invest in employer securities,[24] but none that goes to the active versus passive management issue.

The common law of trust, on which ERISA's prudent-person rule is based, does not classify "specific investments or courses of action [as] prudent or imprudent in the abstract."[25] And consistent with this principle, the DOL has opined that "whether a particular fund or investment alternative satisfies [ERISA's prudence] requirement … is an inherently factual question, and … the appropriate plan fiduciaries must make this determination, based on all the facts and circumstances of the individual situation."[26] In short, ERISA does not limit the type of investment strategy that can be used for plan investments.

[19] *U.S. Airways, 497 F.3d at 413.*

[20] *Id. at 420.*

[21] *Id. at 421.*

[22] *Id. at 424.*

[23] *Massachusetts Mut. Life Ins. Co. v. Russell, 473 U.S. 134, 146 (1985).*

[24] *ERISA § 407(a)(2).*

[25] *Restatement (Third) of Trusts, § 90 cmt. e(1).*

[26] *DOL Advisory Opinion 98-04A (May 28, 1998).*

The DOL has never opined that actively managed funds are less appropriate for use in 401(k) plans than passively managed funds

The DOL says fiduciaries may invest in QDIAs – and avoid potential liability for losses – in the absence of investment direction from plan participants.

The DOL has never opined that actively managed funds are less appropriate for a 401(k) plan than passively managed funds. In fact, when the 401(k) fee cases started to gain traction more than a decade ago, the DOL opposed proposed legislation by Representative George Miller (D. CA) – the 401(k) Fair Disclosure for Retirement Security Act of 2007 – that would have required 401(k) plans to offer at least one index fund as an investment option. At that time, the DOL expressed concern with legislative proposals "that would mandate specific investment options – limiting the ability of employers and workers together to design plans that best serve their mutual needs."[27] This neutral position on active versus passive is a key fact for fiduciaries to keep in mind.

Since then, in adopting the participant disclosure regulation under ERISA section 404(a) in 2010, the DOL included a model disclosure chart that included both index and actively managed funds.[28] This is not surprising in that many 401(k) plans included – and still include – actively managed funds as investment options. Importantly, nothing in the participant disclosure regulation or the Federal Register notice containing the DOL's commentary suggests that the DOL viewed passively managed funds as more appropriate for a 401(k) plan than actively managed funds, or vice versa.[29]

Additional evidence of the DOL's neutrality on active versus passive management can be found in the DOL's regulation on qualified default investment alternatives ("QDIAs"). Plan fiduciaries may, in the absence of investment directions from plan participants, invest plan participant account balances in a QDIA and avoid potential liability for investment losses.[30] One of the permitted forms of a QDIA is a managed account option,[31] which could involve an investment manager allocating participant account balances to the available investment alternatives under the plan for a management fee. This option is a form of active management.

More recently, the DOL issued a proposed rule on whether plan fiduciaries, in making investment decisions for a plan, may consider "climate change" and other environmental, social and governance ("ESG") factors. Importantly, the proposed rule contemplates plan fiduciaries considering "any material risk-return factor," including those relating to "climate change and other ESG factors," and being permitted to select for inclusion in the plan's investment lineup active strategies that consider ESG factors. It stands up to reason that, if DOL felt that one strategy should be favored over another, the DOL would not have proposed a rule that would permit plan fiduciaries to select active strategies that take into account ESG considerations.

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27 DOL Testimony to the Committee on Ways and Means, U.S. House of Representatives (Oct. 30, 2007).

28 29 C.F.R. § 2550.404a-5.

29 In connection with the DOL's now-vacated regulation redefining the regulatory definition of an advice fiduciary, the DOL had noted that "the prevailing (though by no means universal) view in the academic literature … [is] that the optimal investment strategy is often to buy and hold a diversified portfolio of assets calibrated to track the overall performance of financial markets." Proposed Best Interest Contract Exemption, 80 Fed. Reg. 21960, 21978 (Apr. 20, 2015). But this statement fell short of the DOL taking a position on the active versus passive management debate and was made in seeking comments on a potentially prohibited transaction exemption for low-cost investment options. Importantly, DOL subsequently declined to pursue such an exemption.

30 29 C.F.R. § 2550.404c-5.

31 29 C.F.R. § 2550.404c-5(e)(4)(iii).

The relevant facts and circumstances concerning investment-related fees include the expected return that could be achieved for the fees paid.

While actively managed funds, in general, have higher fees than passively managed funds, and the DOL has, at times, emphasized the impact of fees on retirement savings, the DOL's own regulation provides that fees have to be considered in light of the "particular facts and circumstances of each case."[32] The relevant facts and circumstances concerning investment-related fees include the expected return that could be achieved for the fees paid.[33] Indeed, the DOL emphasizes considering the risk and return (presumably, net of fees) characteristics of a fund, rather than fees, in isolation: "To act prudently, a plan fiduciary must consider, among other factors, the availability, riskiness, and potential return of alternative investments for his plan."[34] Thus, the DOL's generic statements about the impact of fees on retirement income should not be viewed as DOL disfavoring active strategies. Instead, a fiduciary can look to many factors – not just fees or returns in an arbitrary window – in making its decisions.

Plaintiffs challenging active strategies have always faced difficulties

As early as 2009, in a lawsuit brought against United Technologies, the court rejected plaintiffs' argument that higher fees of actively managed funds necessarily made the funds inappropriate for use in 401(k) plans.[35] The court held that the plan fiduciaries' process for selecting actively managed funds, which included consideration of potential investment performance, fees and fund managers' experience, was prudent.[36] The court also held that it was not enough for the plaintiffs to allege that the selection of actively managed funds was imprudent without showing which particular investment decisions were imprudent.[37]

Similarly, in a case brought against Boeing, plaintiffs challenged "the [plan fiduciaries'] decision to select actively managed [mutual funds,] which [the plaintiffs alleged] were not reasonably expected to outperform low-cost passive index funds."[38] The plaintiffs, however, did not succeed in this general attack on the value of active management, and the settlement agreement reached in the case does not include Boeing agreeing to stop using actively managed funds.[39]

The Boeing settlement does include Boeing's agreement to retain an independent investment consultant to review whether a technology sector fund is an appropriate investment option for the plan.[40] But the basis for the plaintiffs' challenge was that the plan's technology sector fund was excessively high-risk in that it was concentrated in a single sector.[41] The plaintiffs could have made the same high-risk argument if a passively managed technology fund was used instead of an actively managed fund.

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[32] *29 C.F.R. § 408c-2(b)(1).*

[33] *See Laboy v. Bd. of Trustees of Bldg. Serv., 2012 WL 3191961, at *2 (S.D.N.Y. Aug. 7, 2012). See also Taylor v. United Techs. Corp., 2009 WL 535779, at *10 (noting that the "selection process [for actively managed mutual funds] included appropriate consideration of the fees charged on the mutual fund options, and of the returns of each mutual fund net of its management expenses").*

[34] *See, e.g., DOL Advisory Opinion 85-36A.*

[35] *United Techs. Corp., 2009 WL 535779, at *10.*

[36] *Id. at *5 and *10.*

[37] *Id. at *10.*

[38] *Spano v. Boeing Co., 294 F.R.D. 114, 118 (S.D. Ill. 2013).*

[39] *Spano v. Boeing Co., No. 3:06-cv-743 (S.D. Ill.), document number 554.*

[40] *Id.*

[41] *See id.*

Court decisions confirm that ERISA does not mandate passive management (with lower fees) over active management.

A lawsuit that was brought against Kraft was unique. In that case, the court ruled that there was a triable issue as to whether the use of actively managed U.S. stock investments was prudent in the company's 401(k) plan.[42] However, this ruling was based on the plaintiffs' allegation that the plan fiduciaries — when acting with respect to the company's defined benefit plan — had concluded that they could not find a U.S. stock investment manager who could reliably outperform the market and removed all actively managed U.S. stock investments from the defined benefit plan. This was an unusual fact specific to the Kraft plan fiduciaries.[43] The case was settled before trial, so it is not clear whether the plan fiduciaries would have been successful in arguing that, despite their subjective beliefs, the selection of actively managed U.S. stock funds was objectively prudent. Indeed, there is case law support for the position that plan fiduciaries cannot be held liable for "objectively prudent investments" regardless of whether the plan fiduciaries made the investments "through prayer, astrology or just blind luck."[44]

More recent court decisions reject plaintiffs' assertion that active strategies are inherently inappropriate for 401(k) plans

Courts have overwhelmingly rejected claims that active strategies are inherently inappropriate under ERISA or that they are otherwise inappropriate for 401(k) plans compared to passive strategies. These cases further confirm that "ERISA does not mandate passive management (with lower fees) over active management."[45]

Notably, in a lawsuit brought against New York University, the court recognized that "the law of trusts, upon which the ERISA duty of prudence is based, recognizes that actively managed funds may be prudent."[46] Several other courts have made similar determinations. For example, in a lawsuit brought against Oshkosh Corporation, the court held that "the fact that the Plan offered certain actively managed options does not establish that Defendants acted imprudently."[47] And in a lawsuit brought against Trader Joe's, the court held that it would not be imprudent to offer "a concentration of actively managed funds."[48]

Courts have also rejected plaintiffs' attempts to compare active strategies to passive strategies. For example, in a lawsuit brought against Washington University in St. Louis, the plaintiffs challenged the plan's actively managed stock fund and real estate fund by comparing the funds to index funds. The court ruled that the plaintiffs failed to state a viable fiduciary breach claim against the plan fiduciaries because, for the actively managed funds, "professional investment managers try to beat the market through picking individual investments" while index funds use "passive management that tries to mimic a market index."[49] The court ruled that the index funds, therefore, were not "meaningful benchmarks," and accordingly, the plaintiffs' allegation that the actively managed funds underperformed (and had higher fees than) the index funds was not sufficient to state an ERISA fiduciary breach claim.[50]

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[42] *George v. Kraft Foods Global, Inc., 800 F.Supp.2d 911 (N.D. Ill. July 19, 2011).*

[43] *This type of argument could also be made against plan fiduciaries that decide not to offer actively managed investment alternatives in a company's 401(k) plan while investing the company's defined benefit plan assets in actively managed funds. So there will always be some risk to plan fiduciaries in taking inconsistent approaches to 401(k) plans and defined benefit plan investments.*

[44] *Fink v. Nat'l Sav. & Trust Co., 772 F.2d 951, 962 (D.C. Cir. 1985).*

[45] *Sacerdote v. New York Univ., 328 F. Supp. 3d 273, 314 n. 114 (S.D.N.Y. 2018), aff'd, 9 F.4th 95 (2d Cir. 2021), and aff'd, 9 F.4th 95 (2d Cir. 2021). See also Smith v. CommonSpirit Health, No. CV 20-95-DLB-EBA, 2021 WL 4097052, at *8 (E.D. Ky. Sept. 8, 2021) (" Fundamentally . . . [fiduciaries are] not obligated to choose the best fund available or to favor passively managed funds over actively managed funds.").*

[46] *New York Univ., 328 F. Supp. 3d 273, 314 n.114.*

[47] *Albert v. Oshkosh Corp., E.D. Wis., No. 20-C-901, (Sept 2, 2020).*

[48] *Trader Joe's Co., 2020 WL 7062395, at *4.*

[49] *Id. at 484.*

[50] *Id. at 486.*

Courts have reasoned that comparison between active and passive strategies are inappropriate, given the significant differences.

In a recent decision involving a plan offered by CommonSpirit Health, the United States Court of Appeals for the Sixth Circuit examined the role and propriety of actively managed funds. As an appeals court, the Sixth Circuit's ruling binds the Federal District courts in Kentucky, Michigan, Ohio and Tennessee. In this case, the Sixth Circuit affirmed the dismissal of claims that the plan fiduciaries should have replaced such funds in the plan with passively managed options.[51] The Sixth Circuit opined that "there is nothing wrong with permitting employees to choose [active funds] in hopes of realizing above-average returns" and confirmed that nothing in the law provides that "a plan fiduciary violates its duty of prudence by offering actively managed funds to its employees as opposed to offering only passively managed funds."[52] The Sixth Circuit explained that actively managed funds, as a class of investments, are not categorically imprudent and that plan fiduciaries are required to "ensure that all fund options remain prudent options" regardless of whether the options are active or passive.[53]

Significantly, the Sixth Circuit recognized the importance for plan fiduciaries to consider actively managed funds given the diverse risk tolerances of plan participants. As a general matter, the Sixth Circuit noted that "[a] retirement plan acts wisely, not imprudently, when it offers distinct funds to deal with different objectives for different investors."[54] The Sixth Circuit further noted that "the absence of any actively managed funds suited for risk-tolerant investors" might actually signal imprudence.[55] Although there is no specific requirement under ERISA to consider active funds after the CommonSpirit Health case, the case provides significant support for the use of actively managed funds.

Multiple courts have also ruled that comparing actively managed and passively managed funds is like comparing "apples and oranges," such that plaintiffs alleging that actively managed funds underperformed and charged higher fees than index funds do not state a fiduciary breach claim.[56] These courts have reasoned that comparisons between active and passive strategies are inappropriate given the significant differences in the strategies' respective investment objectives, management styles and other risk/return characteristics.[57]

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[51] *Smith v. CommonSpirit Health, 37 F.4th 1160 (6th Cir. 2022).*

[52] *Id. at 1165.*

[53] *Id. at 1166.*

[54] *Id. at 1167.*

[55] *Id.*

[56] *See, e.g., Wehner v. Genentech, Inc., No. 20-CV-06894-WHO, 2021 WL 507599, at *10 (N.D. Cal. Feb. 9, 2021) (holding that plaintiff "cannot rely on 'apples-to-oranges' comparisons of an actively-managed fund's fees to a passively-managed index fund's fees due to the differences in the way the funds are managed"); Kendall v. Pharm. Prod. Dev., LLC, No. 7:20-CV-71-D, 2021 WL 1231415, at *9 (E.D.N.C. Mar. 31, 2021) (holding that " comparing actively-and passively-managed funds" would be an improper "apples and oranges" comparison and thus passive funds "cannot create a meaningful benchmark" for active strategies); Salesforce.com, Inc., 2020 WL 5893405, at *3 (noting that "passively managed funds . . . cannot serve as meaningful benchmarks for actively managed funds" given their different management approaches and risk/return characteristics); Land O'Lakes, Inc., 518 F. Supp. 3d at 1303 (concluding "that the passively managed and actively managed funds identified in the complaint are not meaningful benchmarks" and that "a comparison between passively managed and actively managed funds is not meaningful because they have different investment strategies"); Anderson v. Intel Corp., No. 19-CV-04618-LHK, 2021 WL 229235, at *8 (N.D. Cal. Jan. 21, 2021) (holding that "simply labeling funds as 'comparable' or 'a peer' is insufficient to establish that those funds are meaningful benchmarks against which to compare the performance of the Intel Funds"); New York Univ., 328 F. Supp. 3d at 315 (finding that attempt to compare passive strategies with active strategies "are inapposite"); CommonSpirit Health, No. CV 20-95-DLB-EBA, 2021 WL 4097052, at *2 (holding that "actively managed funds and passively managed index funds are not ideal comparators").*

[57] *See supra note 60.*

Courts appear to hold the view that the prudence of each investment is not assessed in isolation, but rather, as the investment relates to the portfolio as a whole.

There is also a recognition that, while passive strategies always follow the market's ups and downs, actively managed strategies can adjust their risk profile compared to the market risk. For example, in a lawsuit brought against Lowe's and Aon Hewitt Investment Consulting, the court gave credit to testimony that an actively managed fund had lower "annualized volatility" compared to a market index.[58] Thus, merely asserting that an active strategy underperformed a market index may not carry much weight with a court.

An interesting claim was asserted in a lawsuit filed against CenturyLink, where the plaintiffs alleged that an investment fund's custom multi-manager strategy was imprudent because the different managers' investment styles would offset each other.[59] The plaintiffs alleged that – due to this offsetting effect – the fund could not have been reasonably expected to outperform the benchmark despite having high expenses due to active management.[60] The court rejected this novel claim, however, by noting that the plan fiduciaries' "evaluation of the merits of the Fund's design, and its analysis of the Fund's subsequent performance, satisfied the prudent person standard." This decision was consistent with ERISA's focus on whether plan fiduciaries undertook a prudent decision-making process.

Importantly, courts have also ruled that there is nothing imprudent about plan fiduciaries offering participants "[investment] options with differing features from which to choose, regardless of whether some perform better than others."[61] While there is case law holding that each investment option included in a plan's investment lineup must be prudent on its own, these courts appear to hold the view that "the prudence of each investment is not assessed in isolation, but, rather, as the investment relates to the portfolio as a whole."[62]

Similarly, the DOL has recognized that "two investments may differ on a wide range of attributes, yet when considered in their totality, can serve the financial interests of the plan equally well."[63] Thus, in DOL's view, "a fiduciary may [for example] prudently choose an investment as a hedge against a specific risk to the portfolio, even though the investment, when considered in isolation from the portfolio as a whole, is riskier or less likely to generate a significant positive return than other investments that do not serve the same hedging function."[64]

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[58] *Lowe's Companies, 2021 WL 4771535, at *34.*

[59] *Birse v. CenturyLink, Inc., No. 17-CV-02872-CMA-NYW, 2020 WL 1062902, at *8 (D. Colo. Mar. 5, 2020), appeal dismissed, No. 20-1137, 2020 WL 5900551 (10th Cir. June 4, 2020).*

[60] *Id.*

[61] *Washington Univ. in St. Louis, 960 F.3d at 485.*

[62] *See, e.g., Pharm. Prod. Dev., 2021 WL 1231415, at *4 ("The court evaluates the contested investments and processes in relation to the whole retirement plan"); New York Univ., 328 F. Supp. 3d at 287 ("Fiduciaries should consider the prudence of each investment as it relates to the portfolio as a whole, rather than in isolation"); CenturyLink, 2019 WL 1292861, at *4 ("Offering exposure to different styles of portfolio management and reducing risks associated with a single manager demonstrate prudent decision-making."). But see U.S. Airways, 497 F.3d at 423 ("Under ERISA, the prudence of investments or classes of investments offered by a plan must be judged individually.").*

[63] *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272, 57278 (proposed October 14, 2021)*

[64] *Id. at 57278.*

Preferring different share classes of certain investments is not enough to state a plausible claim for breach of fiduciary duty, the court found.

Litigation claims challenging investments in higher-expense share classes should not be confused with claims alleging that actively managed funds are inherently inappropriate for use in a 401(k) plan

In a lawsuit brought against Wal-Mart, plaintiffs alleged that the plan fiduciaries imprudently selected retail class shares of mostly actively managed mutual funds as investment options in the plan.[65] The plaintiffs argued that due to the size of the Wal-Mart plan and its bargaining power, equivalent institutional class shares with lower expenses could have been offered.[66] Thus, the claims in the Wal-Mart case centered around the payment of higher fees for the same investment strategy and not whether the investment strategy was active or passive. (Both actively managed and passively managed mutual funds have multiple share classes.) The settlement agreement reached in the case does not restrict Wal-Mart's ability to continue to use actively managed funds.[67]

While the use of retail class shares of mutual funds is a different issue from the active versus passive management issue, we note that there have been several court decisions concluding that plan fiduciaries did not breach their fiduciary duty in offering retail class shares of mutual funds in their 401(k) plan. For example, in the lawsuit brought against Oshkosh Corporation, the court stated that plaintiffs' "preference for different share classes of certain investments is not enough to state a plausible claim for breach of fiduciary duty."[68] Another rationale in these decisions is participant choice: i.e., that the participants could have chosen to invest in less expensive investment alternatives that were also available in the plan.[69] This rationale would, of course, also apply to the plan participant's decision to invest in actively managed funds when less-expensive passively managed funds are also available in the plan.

Notably, there is a growing recognition — even by the plaintiffs' bar — that share class expenses are only a part of a plan's overall plan expenses. For example, in a lawsuit filed against Juniper Networks, the plaintiffs allege that the plan fiduciaries should have selected *higher* expense share classes because they made available "revenue sharing . . . that is returned to the participants directly or used as a credit against [plan expenses]."[70] The plaintiffs assert that " a prudent plan fiduciary understands that the higher 'sticker' price" would be irrelevant given that the "service provider returns excess revenue to the Plan and its Participants."[71]

Conclusion

As we highlighted in this article, ERISA does not favor one type of investment strategy over another and — provided that the fiduciaries act prudently in selecting and monitoring investment funds — including actively managed funds in a plan's investment lineup could be an effective approach to reducing the fiduciaries' potential liability.

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[65] *Braden v. Wal-Mart Stores Inc., 590 F. Supp. 2d 1159, 1164 (W.D. Mo. 2008) vacated and remanded, 588 F.3d 585 (8th Cir. 2009).*

[66] *Braden v. Wal-Mart Stores Inc., 588 F.3d 585, 590 (8th Cir. 2009).*

[67] *Braden v. Wal-Mart Stores, Inc., No. 6:08-cv-3109 (W.D. Mo. filed Mar. 27, 2008), document number 229.*

[68] *Oshkosh Corp., 2021 WL 3932029, at *6.*

[69] *See, e.g., Hecker v. Deere & Co., 556 F.3d 575, 590 (7th Cir. 2009) ("If particular participants lost money or did not earn as much as they would have liked, that disappointing outcome was attributable to their individual choices. Given the numerous investment options, varied in type and fee, neither Deere nor Fidelity (assuming for the sake of argument that it somehow had fiduciary duties in this respect) can be held responsible for those choices.").*

[70] *Reichert v. Juniper Networks, Inc., No. 3:21-cv-06213, (N.D. Cal. filed Aug. 11, 2021).*

[71] *Id.*

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