

Sixth Circuit: Alleging That Index Funds Outperformed Managed Funds Fails to State a Breach of the Duty of Prudence Claim (Securities Law Alert)

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On June 21, 2022, the Sixth Circuit affirmed a district court's dismissal of a putative class action alleging that a healthcare company and its 401(k) plan administrator breached the duty of prudence under ERISA by offering several actively managed investment funds when available index funds offered higher returns and lower fees. *Smith v. CommonSpirit Health*, 37 F.4th 1160 (6th Cir. 2022) (Sutton, J.). The court held that plaintiff failed to plead that defendants acted imprudently in offering the managed funds by alleging only that the managed funds' performance trailed the index funds' performance over a period of five years.

Background

Plaintiff, a former healthcare company employee, participated in the company's defined contribution 401(k) plan. The plan offered several actively managed funds and several index funds. Plaintiff commenced a class action against the company and the plan administrator claiming breach of fiduciary duty under ERISA,^[1] arguing that it was a breach of the duty of prudence for defendants to offer actively managed investment funds when available index funds offered higher returns and lower fees. Plaintiff pointed to three-year and five-year periods in which three actively managed funds trailed the rates of return for related index funds. The district court dismissed the case, concluding that plaintiff failed to allege facts from which it could plausibly infer that the company and plan administrator acted imprudently.

The Duty of Prudence Is Context Specific

On appeal, the Sixth Circuit considered various Supreme Court precedents concerning the duty of prudence under ERISA. Under *Tibble v. Edison Int'l*, 575 U.S. 523 (2015), a fiduciary's duty of prudence creates "a continuing duty to monitor trust investments and remove imprudent ones." The Court also has stated that "[b]ecause the content of the duty of prudence turns on the circumstances prevailing at the time the fiduciary acts, the appropriate inquiry will necessarily be context specific." *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409 (2014). In addition, the Court has recently held that, because ERISA fiduciaries face difficult tradeoffs, "courts must give due regard to the range of reasonable judgments a fiduciary may make based on her experience and expertise." *Hughes v. Nw. Univ.*, 142 S. Ct. 737 (2022).

The Sixth Circuit held that plaintiff failed to plausibly plead that the company acted imprudently merely by offering any actively managed

funds in its mix of investment options as a general matter. With respect to the specific funds, the court also held that plaintiff failed to plausibly plead that the company violated ERISA by imprudently offering these specific actively managed funds. After noting index funds’ positive features (mix of investment types and low management fees), the court stated that those features do not “make all other fund types imprudent.” In other words, the fact that index funds have positive features does not mean that actively managed funds do not also have positive features or that some investors may not prefer managed funds. The court pointed out that while an actively managed fund may cost more than an index fund, it may generate greater returns in the long term.

Merely Alleging Another Investment Performed Better Does Not Plead an Imprudent Decision

The court stated that while a plaintiff generally must identify an alternative course of action (*e.g.*, another fund in which the plan might have invested) to show imprudence, alleging such an alternative course of action is not sufficient to plead a claim. Rather, the court explained that “these claims require evidence that an investment was imprudent from the moment the administrator selected it, that the investment became imprudent over time, or that the investment was otherwise clearly unsuitable for the goals of the fund based on ongoing performance.” Accordingly, the court concluded that merely pointing to another investment that has performed better over a five-year period does not plausibly plead an imprudent decision. The court observed that to rule otherwise would mean that every actively managed fund with below-average results over the most recent five-year period would create a plausible ERISA violation; this in turn could cause plan administrators to avoid including any managed funds as plan options. The court noted that its reasoning was similar to how the Eighth Circuit had evaluated a similar claim in *Davis v. Washington University in St. Louis*, 960 F.3d 478 (8th Cir. 2020). In *Davis*, the Eighth Circuit concluded that it was not imprudent for a fiduciary to offer both actively managed stock and real estate funds along with passively managed funds. The *Davis* court explained that the two general investment options “have different aims, different risks, and different potential rewards that cater to different investors. Comparing apples and oranges is not a way to show that one is better or worse than the other.” Refusing plaintiff’s invitation to compare the performance of actively managed funds and index funds within a five-year timeframe, the Sixth Circuit concluded that ERISA “does not give the federal courts a broad license to second-guess the investment decisions of retirement plans.”

[1] 29 U.S.C. § 1132(a)(2).

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