Is Your Diligence Due?

The Legal Landscape Has Changed for Retirement Plans

By CHARLIE EPSTEIN

You've finally done it! You've built the perfect retirement plan that meets your employees' needs and shields you from all fiduciary liability. Then you wake up and discover that you are being sued by a disgruntled employee dissatisfied with the investment choices in your retirement plan.

Sound farfetched? Hardly.

The legal landscape has changed significantly in the last few years, and corporate officers who serve as 401(k) investment fiduciaries are legally responsible for participants' investment decisions — not just for investment options, but also for the direction given by the participants. It used to be that the major player on the plaintiff's side of benefit-related lawsuits was the U.S. Dept. of Labor. Now, the plaintiff's bar has essentially found the pension system. Attorneys are aggressively pursuing any cause of action against plan sponsors that they believe will make themselves and their plaintiffs, whomever they are, money!

What is a plan fiduciary to do? ERISA requires these individuals to diversify plan investments and to choose investments in a prudent manner. The Department of Labor (DOL) has stated, "the only circumstances in which ERISA relieves the fiduciary of responsibility for a participant-directed investment is when the plan qualifies as a 404(c) plan." Section 404(c) relieves plan fiduciaries of liability for investment losses when a plan participant or beneficiary exercises independent control over the investments of his individual account.

However, too many plan sponsors believe that all they must do to be a 404(c) plan is to:

- Offer daily valuation;
- Offer at least three different investment options; and
- Hand out prospectuses to plan participants.

While complying with those criteria will put a plan well on its way to being a 404(c) plan, they would not be sufficient. In fact, while many 401(k) programs meet the operational structural requirements to comply with 404(c), the area in which most inadvertently fall short is simply to acknowledge officially their intent to comply with 404(c) — and to tell participants of that intent and what it means.

The good news is, if the plan complies with these regulations, the plan fiduciaries receive a benefit — relief from liability for investment losses due to the participant direction of investments. If the plan fails to comply, fiduciaries don't get this benefit, but the failure doesn't cause a breach of ERISA, and there is no penalty for failing to comply. Put another way, because 404(c) provides a defense for plan fiduciaries against a possible claim by a plan participant — but doesn't mandate compliance — the plan fiduciaries are not exposing themselves to additional liability if they try to comply with 404(c) but fail.

Amazingly, many studies today and surveys of company retirement plans show that few plans satisfy the roughly 25 requirements of this regulation. Most of the investment fiduciaries for 401(k) plans are probably unknowingly and legally responsible for the prudence of participant-investment decisions.

A recent class-action lawsuit filed against the Enron 401(k) plan focuses on the significant value of complying with ERISA 404(c). The DOL has filed an amended brief to the secretary of Labor in opposition to motions by the defendants, including Enron's committee members, in their attempt to dismiss the class-action lawsuit filed against them. The brief lays out the DOL's thinking on a host of important fiduciary issues and concludes, "the only circumstances in which ERISA relieves the fiduciary responsibility for a participant-directed investment is when the plan qualifies as a 404(c) plan." The brief goes on to explain that a fiduciary "is not liable for losses to the plan resulting from the participant's selection of investments in their own account, provided that the participant exercised control over the investments and the plan met the detailed regulations of a Department of Labor regulation." The brief then points out that the 404(c) regulation sets out the detailed conditions for qualifying as a 404(c) plan.

If fiduciaries are legally responsible for participant investments, why aren't fiduciaries taking the steps necessary to be protected by the 404(c) shield? Why would fiduciaries expose themselves to claims from the widow of a 65-year-old participant who invested entirely in a technology fund? What about the 25-year-old who is invested entirely in cash year after year? People would argue that those are imprudent decisions, and unless the plan complies with 404(c), they have the legal responsibility of the plan's investment fiduciaries.

It is inconceivable that a responsible officer or committee member would accept that potential liability if they understood the risks and if they knew that section 404(c) was available. It appears that attorneys, consultants, and investment advisors of retirement plans have not done an adequate job of explaining 404(c) and its value to plan sponsors.

So what does it take to comply? There are roughly two dozen required items which you must be sure are covered. A complete list cannot be provided in this space; however, some of the most important items to be considered are:

- The plan must inform the participants that it intends to be a 404(c) plan;
- It must identify the 404(c) fiduciaries;
- It must explain that legal responsibility and liability for selecting among the investment options is being transferred to the participants;
- If the plan fails to make these disclosures, then no matter what else is done, 404(c) protection is lost.

A plan must also provide specific information to the participants about the plan's investment options, including (among other things):

- A description of the investment alternatives available;
- A general description of investment objectives and risk and return characteristics of designated investment alternatives;
- Information on fees and expenses that affect the participant's return; and
- Copies of prospectuses, proxy statements, and reports on publicly traded securities to the extent these are available to the plan.

Many mutual funds and insurance companies provide most, if not all, of this information to the participants automatically. The biggest requirement that many plans fail to meet is providing confirmations to participants of investment changes to the plan.

Of course, you don't get a free ride by complying with just 404(c) or eliminating the potential exposure to liability. Plan fiduciaries still have the responsibility for selecting investment options offered to participants and for monitoring that the options continue to be appropriate.

A 401(k) plan's investment program requires more than just the top investment choices of the month. If the plan fully complies with 404(c), fiduciaries still are accountable for the available options in the plan. DOL notes, "the scope of ERISA 404(c) relief is limited to losses or breaches which resulted from the participants' exercise of control. Section 404(c) plan fiduciaries are still obligated by ERISA's fiduciary responsibility provisions to prudently select the investment options on the plan and to monitor their ongoing performance."

Every retirement plan fiduciary should have a due diligence process in place that provides the following on a regular basis:

- An investment policy statement that spells out the criteria for creating and monitoring the investment program;
- A carefully orchestrated and written selection of investment options;
- A due-diligence process that monitors the investment performance of the managers selected and a methodology for hiring and firing these managers on an ongoing basis; and
- Regular communication to participants on investment performance and manager changes.

For a detailed copy of the actual 404(c) regulations, contact your professional advisor. By taking prudent steps now and learning the new rules of the road, plan fiduciaries can keep themselves out of harm's way.

Charles D. Epstein, CLU, ChFC is a registered investment advisor; www.epsteinfinancial.com.