The 401(k) Perfect Storm

By Ary Rosenbaum, Esq.

The phrase "The Perfect Storm" sprang from the 1997 book--and later, the 2000 film--of the same title. The idiom has since come to refer to any event in which a possible, but highly unlikely, combination of circumstances serves to dramatically aggravate a situation.

Since 2008, the worst stock market returns since the Great Depression, coupled with already existing trepidation concerning 401(k)plan fees and a lack of their disclosure, created a Perfect Storm in the world of retirement plans. In the wake of that storm, our faith in 401(k) plans began to sink.

When I graduated with an L.LM degree in taxation in 1998, my first position was with a small law firm that drafted retirement plan documents for small to medium sized employers. It was there I met Marge, a retirement professional whose career stretched way back; by the time I came on the scene, Marge had been working in the industry for nearly 40 years--long before the Employee Retirement Income Security Act of 1974 (ERISA) went into effect. It was Marge who introduced me to the ins and outs of retirement plans, especially 401(k) plans.

Growing up, I had heard about 401(k) plans and was eager to begin deferring my earnings into such plan. I thought 401(k) plans were the ultimate retirement plan. But Marge set me straight. Marge pointed out that while 401(k) plans did offer tax deferred savings, those same plans shifted the responsibility of establishing retirement savings from the employer to the employee--not a great feature in her estimation.

Marge warned me that when it came to investing in 401(k) plans, I should always look before I leap. Marge's warning came years before the dot.com bust and long before the credit crisis cast suspicion on the wisdom of relying on 401(k) plans to serve as a proper savings vehicle for employees. Marge certainly never heard of a Perfect Storm, but she was ahead of her time.

Ever since 401(k) plans arrived on the horizon in the early 1980's, they have rapidly replaced defined benefit plans as the retirement vehicle of choice for small to medium size employers. In the last several years, due largely to escalating costs, even large employers have phased out defined benefit pension plans.

Defined benefit plans can be expensive to maintain, but typically guarantee workers a fixed monthly retirement income based on their length of service and final years of salary.

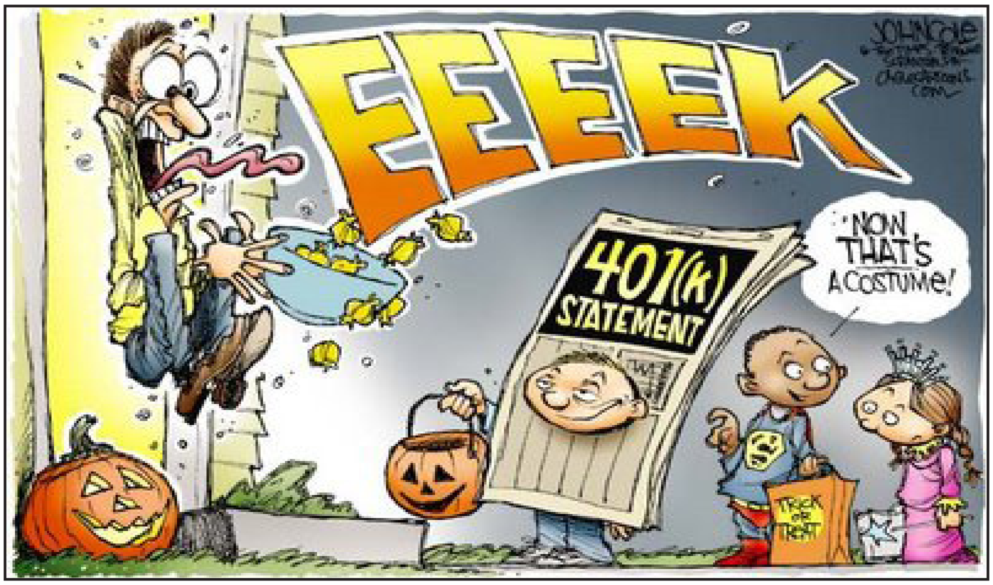
Defined benefit and money purchase pension plans require employer contributions for a plan that require minimum funding. But, 401(k) plans allow employers to establish, increase, decrease and/or eliminate discretionary matching or profit sharing contributions at any time. During prosperous times, an employer might choose to contribute a particular sum or percentage to his employees' 401(k) plan, while during times of economic downturn, that employer may choose to reduce or eliminate such contributions

Thus, while employers' costs to maintain defined benefit plans can vary unpredictably from year to year due to employee demographics and plan investment returns, 401(k) plans provide employers with a predictable cost platform. In fact, with a 401(k) plan the employer's only obligation is to pay plan administration and support costs. Even then, some or all of those plan administration costs can be passed on to plan participants. While cost and the ability to delegate administration to a third party administration firm ("TPA") make 401(k) plans very attractive for small to medium-size companies, many of these employers are under the mistaken belief that the design of a 401(k) plan shields them from lawsuits brought about by plan participants. This is a fallacy.

Operating a retirement plan is like operating a car: you have to do conssponsor may be exposed to liability from a participant lawsuit. With both the auto and the plan, you have to "lift up the hood" from time to time and see what's there.

Under the "Prudent Man Rule" of ERISA, a 401(k) plan fiduciary must discharge his or her duties with the care, skill and diligence that would be exercised by a reasonably prudent person who is familiar with such matters. Therefore, an employer must be aware of its plan's costs, structure, and choice of plan investments. In effect, ERISA requires the plan sponsor to "look under the hood."

No Perfect Storm discussion would be complete without including the topic of plan fees. It's been more than 35 years since the enactment of ERISA and the DOL will implement a rule requiring TPAs to reveal the cost of operating the plan in 2011.



401(k) plan expenses can have a significant impact on the rate of return plan participants' experience. Plan fiduciaries have an obligation to carefully identify all charges that will be incurred by the plan and to ensure they are reasonable, both in light of the services provided as well as what is being charged in the marketplace. Problems arise when the TPA does not disclose all the administration fees they are receiving when directing an employer's 401(k) plan. Plan fiduciaries should review their plan administration every year to make sure that the costs for plan administration are reasonable for the service the TPA is providing.

The issue concerning plan investments is especially pressing given today's financial environment. Most small to medium sized employers are under the mistaken impression that if they offer participants a choice of mutual funds in their 401(k) plan, they are shielded from liability, even if the funds perform poorly and the participant loses money. But the opposite is true. After selecting 401(k) plan investment funds, the plan sponsor must make an effort to review the funds' performance annually, if not quarterly.

A plan sponsor should also implement and consistently update an investment policy statement. This helps ensure that the plan's investment offerings are consistent with the company's criteria for investment selection.

Many small to medium-size employers either do not update their investment policy statement, or even have one in place at all. Another problem with participant direction of investment election involves employee education.

Under ERISA 404(c), a participant is considered to exercise control over the assets in his account only to the extent that he or she has an opportunity to obtain sufficient information to make informed investment decisions. This means the control a participant exercises over his or her investments is in direct proportion to the investment information the employer provides. Instead of providing participants with investment information, many plan sponsors merely distribute enrollment forms to participants and call it a day. If a participating employee is provided little or no investment information, the plan sponsor can be held liable for a participant's investmentloss; this defeats the purpose of having an ERISA 404(c) participant-directedplan in the first place.

I was flabbergasted when I joined a highly regard law firm a few years back and was given Morningstar profiles of the mutual funds in the plan. Upon review, I asked who picked out these funds because the mutual funds looks like top ranked funds, from 1999. The human resources director informed me that the plan had no financial advisor, no investment policy statement, no education for plan participants, and the funds were selected by one of their former ERISA partners 10 years earlier. Needless, I advised her to change that quickly and she did by hiring a new financial advisor that could correct these glaring liabilities quickly.

Individual plan sponsors have often turned to investment professional to conduct semi-annual or quarterly employee education meetings with regard to plan investments. But such a move is even more vital in today's volatile stock market. While many small to- medium-sized employers may not have the time or expertise to be concerned with the operation of their 401(k) plan, these same employers would be wise to engage the help of responsible investment professionals who can help them navigate the choppy waters of this 401(k) Perfect Storm to minimize as much liability and loss as possible.

I believe Marge, wherever she is, would wholeheartedly agree.

THE ROSENBAUM LAW FIRM P.C.

The Rosenbaum Law Firm P.C.
734 Franklin Avenue, Suite 302
Garden City, New York 11530
(516) 594-1557

http://www.therosenbaumlawfirm.com

Follow us on Twitter @rosenbaumlaw