The Smaller Stuff Creates the Biggest Liability Pitfalls for 401(k) Plan Sponsors

By Ary Rosenbaum, Esq.

When I was a kid, I had an Intellivision. For those people born after 1980, Intelliivision was video game console that had better graphics than an Atari 2600 but people didn't buy. One of my favorite games on Intellivision was Activision's Pitfall that was far superior than the Atari version. Pitfall was a rip off of Raiders of the Lost Ark where the character Pitfall Harry tried to navigate a jungle by leaping over logs and using vines to jump over alligators. I actually got a patch for having a high score that my Aunt actually achieved. Plan sponsors have their own game of Pitfall, but the problem is that unlike the video game version, the pitfalls are usually invisible and are actually small mistakes. This article is how the small stuff can create the greatest liability pitfalls for 401(k) plan sponsors.

Not Having an ERISA bond

Every retirement plan subject to ERISA, requires a bond to protect plan assets against theft from plan fiduciaries. It's the most basic line of defense for plan sponsors, yet so many plans don't have it. I have seen a client whose plan assets were lost in Bernie Madoff's ponzi scheme who had no ERISA bond. Not only does it help protect plan assets from theft, but whether you have an ERISA bond or not is a question for Form 5500. I am willing to bet that stating that a plan doesn't have an ERISA bond on Form 5500 will target that plan for a Department of Labor (DOL) audit.

Not Having Fiduciary Liability Insurance

An ERISA bond has nothing to do with fiduciary liability insurance, which is purchased to protect plan fiduciaries from litigation and liability costs associated with operating a retirement plan. Every retirement plan should purchase such insurance even if it's not required because litigation even for frivolous claims can be burdensome. I once had a client who had $1 million worth of litigation costs from a class action lawsuit regarding a 403(b) plan of theirs and the insurance paid for almost all of it (the client was responsible for the $100,000 deductible) that was ultimately dismissed against them. You will be surprised how reasonable the rates of fiduciary liability insurance are, so contact your insurance broker or me for more information.

Not Hiring A Financial Advisor

It is surprising to see so many retirement plans that don't actually have a financial advisor. While we may or may not be able to invest on our own, the rules are different with retirement plans. As an individual, you are responsible for your gains and losses. When you operate a retirement plan as a plan sponsor, trustee, or another fiduciary, you have a duty, a fiduciary duty to plan participants and beneficiaries. A fiduciary duty is the highest duty of care in equity and law and the role of a financial advisor for a retirement plan is a lot more than just picking mutual funds. Unless you are a financial advisor, you need to hire one for your plan.

Not Having an Investment Policy Statement

Even if your plan has a financial advisor, you may not have a good one. There are many plans out there with a financial advisor who does nothing more than collect their \ fee every quarter. One of the important tasks that a competent financial advisor does is to protect their clients from liability and the easiest ways is to develop an investment policy statement (IPS). What is an IPS? An IPS describes the criteria for what types of investment options are selected as well as to when they should be replaced (when they are no longer fitting those criteria). It's a blueprint as to why investments are selected and replaced and they are needed for a plan whether investments are directed by participants or by trustees. It's one of the easiest ways to minimize liability in any lawsuit regarding investment losses, so it's surprising that so many plans don't have one, especially those plans with financial advisors. It's an easy, but extremely important component of any retirement plan, so important that DOL representatives have been asking for them when doing plan audits.

Not Providing Education to Plan Participants

Section 404(c) of ERISA is one of the most poorly understood topics in all of retirement plans. Section 404(c) offers relief to plan sponsors for the losses incurred by plan participants if the plan participants get to direct the investment of their account under a defined contribution plan (which includes a 401(k) plan). The problem is that the relief is limited or extended to the amount of information that you provide participants in order for them to make educated decisions about their investments. So the old trick of just providing Morningstar profiles of funds isn't going to cut it, so it's necessary for plan sponsors to provide enough investment education to plan participants to limit their liability. In addition thanks to new DOL regulations, offering investment advice to plan participants can now be done by your current provider (if they adhere to the regulations) or you can farm it out to an outside provider. Investment advice is obviously more valuable to a participant because advising them how to invest is more valuable than giving them basic investment education (i.e., the difference between equity and income investments).

Not Reviewing Plan Investments

It's not enough to have an IPS and provide education to plan participants; plan sponsors need to make sure that the investment options aren't like last week's bread, stale. Working with their financial advisors, a plan sponsor has to make sure that the investment options still fit the criteria set forth by the IPS. A running joke of mine is that if you want to see which mutual funds were great and popular 5 years ago, just check the most popularly held 401(k) invested mutual funds today. Having your 401(k) plan serve as a museum for formerly high returning mutual funds does a disservice to plan participants and raises your potential liability. As we remember with polyester leisure suits and ruffled shirts, styles change and what was great and popular years ago is out of style today. That is why you need you have a financial advisor review your investment lineup with you every 6 months (the larger the plan, perhaps more frequent) to ensure that the investment options still fit the criteria set forth by the IPS. Like the tagline in the movie Casino, no one stays on the top forever. The same can be said about any investment option, so it's important that they be reviewed whether the plan's investments are participant directed or not.

Not Reviewing Plan Expenses

While we effectively have had the last 10+ years of very little gains to our retirement savings, there has been a boon in retirement plan litigation, with much in the litigation concerning plan expenses. As a plan sponsor, you have a fiduciary duty to pay reasonable expenses, especially if plan participants are paying for the plan's expenses from their own individual accounts. Now with fee disclosures being delivered to you from your plan providers and your requirement to provide disclosure to participants if they direct the investments, there is more pressure to review plan expenses. Reviewing plan expenses isn't just looking at the disclosures and putting it in a drawer, it means checking them based on the services provided by benchmarking them against what is being offered by other providers. This benchmarking should be done every 1-3 years (based on the size of the plan) and should be documented. It should be noted that it's not about finding the lowest cost provider, it means paying expenses that are reasonable in relationship to the services provided.

Not Reviewing Plan Providers

When you hire a contractor for your home, you have someone to blame when the house expansion goes south. When it comes to the administration of your plan, you don't have that luxury. While you can delegate the administration of your plan to a TPA or a financial advisor or an ERISA §3(38) fiduciary, you still ultimately bear the burden of responsibility if something goes wrong. While you can blame your providers for their errors, you are still on the hook for liability. That is why it's important to review your plan providers to ensure that they are doing the job they say they are doing, so to avoid potential heartache later. Consider using a retirement plan consultant and/or ERISA attorney (cough, cough) to make sure that your providers are doing a competent job.

Being a plan sponsor is a tough job and there is a tremendous amount of potential liability that goes with it. While it's a tough job, taking care of the small stuff that goes with it can minimize most of the liability. Good housekeeping goes a long way, so neglecting the small stuff will create the biggest retirement plan problems later. By taking care all of the items in this article, you will eliminate most of the liability threats that go along with being a retirement plan sponsor.

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