The 401(k) Problems With Former Employees

By Ary Rosenbaum, Esq.

I always say that the real reason I never hired employees for my law firm is that I was once an employee too. That means that no matter what my employer could do, there would probably be something I still would complain about. One of the lurking dangers in your 401(k) plan is former employees who still have account balances in your plan and my suggestion to you that as a 401(k) plan sponsor, you should minimize your liability exposure by trying to get these former participants to roll out their account balance and cash them out if they are under the cash-out provision.

They are participants

Regardless of their position as a former employee, they are participants in your 401(k) plan. When it comes to ERISA and participant rights, there is absolutely no differentiation between current and former employees. Former employees have the same rights and responsibilities as participants as current employees. While former employees don't have the right to any contributions or the right to defer, they have the same rights in terms of ERISA protected rights for plan participants.

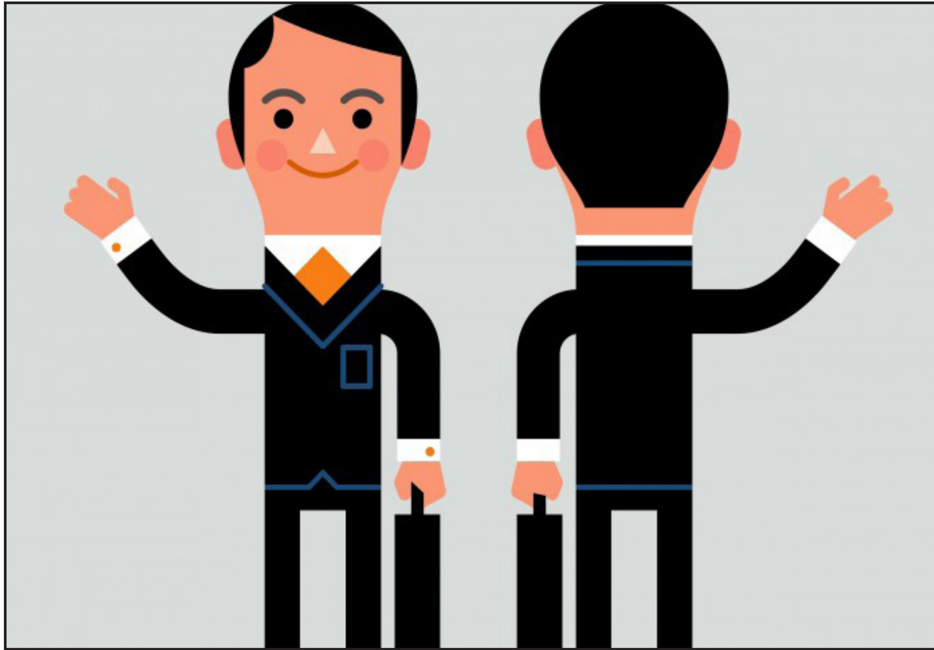
Keeping up with notices

One of the most important tasks you have like a 401(k) plan sponsor and plan fiduciary is providing ERISA required notices. It is certainly more difficult to handle the distribution of notices to former employees than it does for current employees. Former employees can move from one part of the country to another, they can fall off the face of the earth. Even with online distributions of notices now allowed, losing track of former employees through bounced emails can be troubling if you don't follow up since that's a sign that you need to mail a notice to an address that may no longer be valid. When dealing with plans that are terminated or full of former employees, bounced mail and emails are a fact of life. As a plan fiduciary, you have a requirement that notices be delivered to all plan participants, former employees can throw a wrench into your job as a plan sponsor.

Participant direction of investments

One of the most misunderstood topics concerning 401(k) plans is the limited liability of plan sponsors in offering participants the right to invest their account balance. The rules that govern participant-directed investments (ERISA §404(c)) aren't understood by most 401(k) plan sponsors who assume wrong that just offering it, absolves them from any liability for participant investment losses. Participant direction of their investments still requires plan sponsors to do something on their end as plan fiduciaries through a prudent process. The process includes meeting the plan's financial advisors and reviewing and replacing investment options. A huge chunk of limiting liability for participant-directed investments is where there is a potential problem with former employees. Limiting liability

for participant direction of investment is dependent on providing enough information to participants to make informed investment decisions. Whether it's investment education or investment advice, the fact is that most former employees are going to fall through the cracks. I can't imagine any 401(k) plan sponsor diligently reaching out to former employees with investment education. I would imagine that most former employees have the same investments in the plan when they left employment. I just believe that most former employees don't bother checking their account balance or rebalance their investments. This is a potential liability headache that any 401(k) plan sponsor like you wouldn't want. Keeping former employees in your plan could be a potential liability headache if the stock market goes through a bear market and former employees want to blame someone and you provided zero investment information to them.



The cost of it

Many 401(k) plan sponsors feel that having assets from former employees is a good thing because plans with a large asset size get better pricing when it comes to daily 401(k) administration. The problem is that those assets belonging to former participants tend not to be the deciding factor when it comes to pricing the plan for 401(k) administrative services. Quite honestly, I feel that small account balances belonging to former employees are a headache for mots plan providers. Also, keeping on too many former employees in your plan may risk you having your 401(k) plan get subject to a plan audit. Whether it's 100 participants or 120 participants (the 80-120 rule), your headcount for purposes of a required plan audit includes former employees. If you never qualified for an audit, but the former employee headcount subjects the plan to it, that is probably an extra $15,000 in added plan administrative expenses. In addition to the cost of the audit, you're also subjecting to yourself to meeting the auditor's multiple requests for information so that they can complete the audit. Of course, the problem with former employees and trimming them from the plan is the involuntary cash-out rule.

The Involuntary Cash-Out Rule

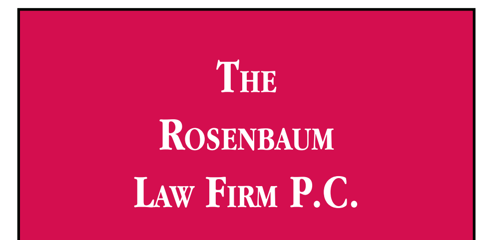
The problem. With dealing with former employees is this thing called the involuntary cash-out rule. If a former employee's account balance is above the cash-out limit (usually $1,000 or $5,000), you need their consent to make a distribution to them after the termination of employment. If they are under the limit, you could cash them out after contacting them that they need to take a distribution directly or a rollover to an Individual Retirement Account or another qualified plan. While your hands are tied with balances over the cash-out limit, you still should be persistent to these former employees to take their account balances with them. Most 401(k) plan sponsors send the distribution forms to the former employee and forget all about them when they don't get the distribution paperwork back. It's important as a 401(k) plan sponsor to consistently reach out to former employees and ask annually whether they will take their money out. As for former employees who are below the cash-out limit, it's important to utilize the provision because there are so many plan sponsors that don't. The involuntary cash-out provision is there for a reason, so use it.

The missing participants

You lose track of former employees and that's a problem when it comes to their account balances, whether they are above or below the involuntary cash-out limit. Almost all 401(k) plan sponsors don't bother with missing participants until they terminate their plan. The Department of Labor (DOL) has focused their concern on missing participants and these dormant account balances. If the DOL is concerned, so should you. As part of your annual request to former employees to take their money, identify which letters bounce back or which emails back bounce. You can easily track down former employees with personal search engines on the Internet. Whether it's a per person or monthly charge, you can easily find people you've lost track of. As with anything you do as a 401(k) plan sponsor, you need to document what you do.

The nature of former employees

Former employees are likelier to sue likelier to complain about you to the DOL than current employees. That is a fact of life and I say this as a former employee. Getting these. Former employees out of your 401(k) plan would be great for you and good for them as it's a tie that no longer has to bind.



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