The Potential Liability of Participant Directed 401(k) Plans

By Ary Rosenbaum, Esq.

As children, we were told the story of Jack and The Beanstalk. Jack sells a cow for some "magic beans" and his mother is so angry, she throws the beans on the ground and a magic beanstalk grows overnight. When it comes to plan sponsors being given the opportunity to sponsor a 401(k) plan that allows for participant direction, they were sold some "magic beans" and told that they were shielded from liability for participant's investment losses. While those "beans" won't turn into a beanstalk, they could lead to some unexpected liability. This article is about the hidden liability of ERISA §404(c) participant directed plans and how to avoid that potential liability as a plan sponsor.

What is ERISA §404(c)?

The general rule is that fiduciaries of retirement plans are going to be liable for all aspects of selection and monitoring of plan investments. That means they are going to be on the hook for any participant claims for any losses incurred in the plan. Section 404(c) is an exception to that rule, but it's a limited exception. ERISA §404(c) applies to individual account plans such as 401(k) and 403(b) plans whose participants can direct investment of their accounts. Under ERISA §404(c), fiduciaries would not be liable for any claim of a breach related to a participant's selection of investments. The problem is that it's only part of the story. ERISA §404(c) isn't all or nothing, it's a process and a plan sponsor that doesn't diligently follow the process may not get the full blanket of protection that ERISA §404(c) offers. That blanket of protection is a sliding scale of protection, the more that a plan sponsor follows a prudent fiduciary process, the more liability protection that they can get.

The "Old Man" offering the magic beans of ERISA §404(c)

Until the 1990s, most retirement plans that could offer ERISA §404(c) participant direction didn't. The reason is because technology allowing easier participant direction took time to catch up with the idea of it. Participant direction under ERISA §404(c) became a really big deal in the late 1990s because of a booming stock market and some fairly new thing called the World Wide Web. The selling of ERISA §404(c) daily valued 401(k) plans was backed by mutual fund companies seeking more distribution of their mutual funds which would certainly raise their revenue through management fees. It is no coincidence that mutual funds became the most popular form of investment of 401(k) plans when ERISA §404(c) participant directed plans became popular.

The Basic Requirements of ERISA §404(c)

Employers that fully comply with 404(c) can shift responsibility for investment losses to plan participants. Basically, ERISA §404(c) offers a "safe harbor" for plan fiduciaries to not be liable for investment losses suffered by plan participants who self-direct their investments. To qualify for this safe harbor, plan sponsors must comply with the requirements for investment selection, plan administration, and plan & investment disclosures before they are exempt from fiduciary liability for losses plan participants incur as a result of their directing their own investments. One major requirement under the safe harbor is that the plan must offer a broad range of investment options. This is a fairly easy requirement to meet. A broad range is defined as at least three investment alternatives. Each option must be diversified, offer risk/return characteristics different from the others, and offer diversification for a participant's overall portfolio when combined. Most defined contribution plans today meet this requirement without a problem. The plan must also allow participants to become informed about and to direct their investments. This opportunity to exercise control must allow plan partici-

pants to give reasonable investment instructions to make their elections, have an opportunity to obtain written confirmation of such instructions, and receive sufficient information to make informed investment decisions. Participants must also be able to make changes to their investments at least quarterly.

The problem of investment selection

One of the biggest problems with ERISA §404(c) is that many plan sponsors neglect to deal with investment selection. They think all they need to do is come up with some investment options for participants to choose and that's it. The idea that a plan sponsor can "set it and forget it" is an absolute mistake that could cause a lot of liability headaches for you as the plan sponsor. As a plan sponsor, investment selection is about a process. First off, you need a financial advisor to help guide you because of the intricacies of dealing with investments and dealing with plan participants. The process needs a blueprint for investment selection and that blueprint is an investment policy statement (IPS). While it's not legally required, an IPS is a perfect tool to show why investments were selected and on what criteria, they are retained or replaced. An IPS has to be a living document, which means it has to be followed. Having an IPS and not following it is more detrimental from a liability standpoint that not having one at all.

Investment selection and fees

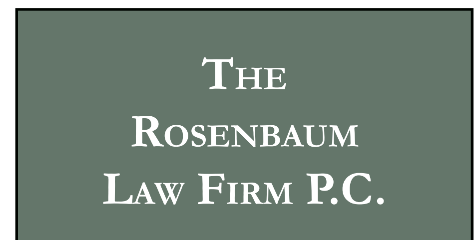
One of the biggest problems in dealing with investment selection is investment expenses. The problem with investment expenses is that investments with high fees certainly cut down on what a participant can save for retirement. That's why there has been a swell of litigation against plan sponsors for the investments offered under the plan. Luckily fee disclosure regulations make the fees associates with investments more transparent, so that means you have no excuse not to be diligent. The biggest concerns over investment expenses are 1) high fees, 2) whether revenue sharing payments paid by the mutual fund to the third party administrator (TPA) was a major reason for investment selection, 3) using mostly proprietary funds of one of the plan providers, and 4) using improper share classes when less expensive share classes were available. In a nutshell, a concern about investment expenses is all about making prudent decisions in only selecting investment options that are reasonable in cost. Selecting mutual funds just because the plan provider offers them, or because the mutual fund company may help defray plan administrative costs, isn't reasonable.

Offering an educational hand to participants

The last prong of getting protection as a plan sponsor under ERISA §404(c) deals with a requirement that most plan sponsors neglect. In order to get that liability protection, plan sponsors need to make sure their plan participants have access to sufficient information about each investment option so that they can make informed investment decisions. What is sufficient information? Well the human resources director at my old law firm gave out Morningstar profiles of the mutual funds offered under the plan before I begged her to hire a financial advisor. I don't believe that this is sufficient information because most plan participants probably can't make heads or tails of those reports. The Department of Labor (DOL) clearly states in the regulations that it does not require the plan sponsor to provide investment advice to plan participants to be a §404(c) plan. However, they did go out of their way to issue an Interpretative Bulletin in 1996 that encouraged plan sponsors to offer investment education by delineating which activities fell under investment education and would not be considered advice. A plan sponsor providing plan information, general financial and investment information, asset allocation information, and interactive investment materials would be allowed to provide that type of investment education. If the DOL gives a blueprint on what investment education is, and encourages plan sponsors to offer it, you need to provide it to plan participants to get §404(c) liability protection.

Want 404(c) protection? Document everything

If you want the full faith and credit of ERISA §404(c) protection, you need to make sure you document everything. Not only does it mean maintaining an IPS, it also means taking minutes for all investment decisions made for the plan. It also means keeping records of all investment education materials given to plan participants. I would also recommend keeping records of all participant enrollment and education meetings, including keeping an attendance sheet. ERISA §404(c) is all about following a process and not about guaranteeing a certain investment result. The way of showing that a process was followed is documenting how it was followed. I call it "papering the process". If you keep good enough records, consider it your get of jail free card if a participant tries to sue you for losses sustained by them in investing their 401(k) account.



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