How to Avoid a 401(k) Lawsuit

By: Jennifer Eller

Cost predictability is an important factor that has driven companies to 401(k) plans and moved them away from traditional defined benefit pension plans. The traditional plans place the investment and funding risk on the employer, while in most 401(k) plans participants are responsible for investing the assets in their accounts, and employer contributions are discretionary or are set as a percentage of employee contributions. One risk to the cost predictability of 401(k) plans that is often overlooked is the potential for class action litigation by plan participants. In addition to the litigation costs, 401(k) lawsuits pit the company against its own employees, which lowers employee morale and reduces productivity. Most 401(k) lawsuits involve fees paid from participant accounts, company stock as a plan investment option, or both. Dozens of fee cases and hundreds of stock drop cases have been filed in the last few years. While a number of things can be done to avoid a 401(k) lawsuit, even plans with state-of-the-art practices sometimes get sued. However, not every preventative measure is created equal. In my experience, there are three steps that can substantially lower the risk that a 401(k) plan will be the target of a lawsuit.

Step One: Fiduciary Governance

A rational, efficient, well organized fiduciary governance structure may be the most effective way to avoid 401(k) litigation, and is a critical element in a successful defense if a case is brought. Corporate 401(k) plans are governed by the Employee Retirement Income Security Act (ERISA). ERISA requires that each plan be managed and administered by one or more persons, called "fiduciaries." Anyone who is responsible for making plan investment decisions is a fiduciary. ERISA subjects fiduciaries to exacting legal standards of care and loyalty. Fiduciaries who breach these duties are personally liable for losses to the plan. As a recent decision by the U.S. Supreme Court made clear, this liability extends to losses suffered by individual participants in their own plan accounts. ERISA's combination of high standards and severe consequences for fiduciaries makes it extremely important that plan fiduciaries are chosen with care, understand their duties and responsibilities, and undertake them with the same focus and support as other job duties.

There is no single optimal fiduciary governance structure. 401(k) plans are often run by one or two fiduciary committees. Committee members are usually drawn from the company's human resources and treasury or finance departments. In a two committee structure, responsibilities for plan administration are typically separated from responsibilities for plan investments. In a single committee structure, these functions are combined. Several considerations are important when designing a fiduciary governance structure. The best structures are those that:

- use the existing organizational structure of the company;

- take advantage of expertise available within the company;

- involve people who have the time to devote to being a fiduciary, but enough perspective to think independently about the needs of the plan;

- clearly define the roles and responsibilities of each individual or committee, and yet are equipped to deal with turnover; and

- are accurately reflected in the plan documents.

Often, a useful step in designing a fiduciary governance structure that is well-suited to the needs of the plan and the culture of the company is to identify the persons who are actually carrying out the plan's fiduciary functions and compare this reality with the structure described in the plan documents. It is not uncommon to find variations between plan documents and actual practice. The next step is to incorporate the efficiencies represented by this evolution into the plan documents, and educate the plan's fiduciaries and support staff about their roles and responsibilities. In general, we don't recommend that a company's board of directors act as a plan's fiduciary (even if the board's sole responsibility is to appoint other fiduciaries). It is usually difficult for the board to devote the time necessary to carry out the duties of a fiduciary. Likewise, we don't recommend having a company's general counsel or other in-house lawyer act as a member of a plan's fiduciary committee because doing so might raise issues regarding the scope of protections available under attorney-client privilege.

Step Two: Company Stock

Plans that offer company stock as a plan investment face a heightened litigation risk. The only sure way to eliminate this risk is not to offer company stock as part of the plan; however, our experience is that the large majority of public companies offer company stock as a plan investment. Many companies strongly believe in the benefits of employee ownership, including increased plan participation and savings rates. If company stock is part of the plan, then a clear and streamlined fiduciary structure can help make sure that all of the plan investment options (including company stock) are properly monitored. In addition, there are a number of specific practices that can help head off stock drop litigation.

For instance, plaintiffs in stock drop litigation often contend that under the plan language describing the company stock fund, plan fiduciaries were not required to limit and should not have limited the investments of the stock fund to company stock. While it should not be necessary in order to ultimately prevail in a stock drop case, amending the plan to clarify the intent of the company that the stock fund be invested exclusively in company stock, except as necessary for liquidity, can be a helpful preventative measure. The plan's investment fiduciaries should understand their role in setting and monitoring how much cash is held as part of the company stock fund (if it is a unitized fund). Ideally, the appropriate plan fiduciary should establish a standard against which to monitor company stock. This standard may be articulated in the plan document or in an investment policy statement. A standard that agrees with ERISA’s presumption in favor of holding company stock in 401(k) plans is one which requires plan fiduciaries to keep company stock as a plan investment option unless there is a serious question as to the short term viability of the company. To reduce the risk of litigation, and to increase the

likelihood of prevailing in a stock drop case, plan fiduciaries should periodically review publicly available information (e.g., credit ratings, SEC filings, and reports) and monitor the company's performance against the monitoring standard. Another aspect of monitoring company stock as an investment option is documenting the fiduciary review. A record, such as meeting minutes, should be maintained documenting the fiduciary's review of plan investment alternatives, including company stock. Finally, communicating clearly and frequently to plan participants regarding the risks of company stock, and the rights of participants to divest their company stock holdings is also helpful.

Step Three: Understanding and Monitoring Fees

Like step two, this step is about mitigating risk by putting the plan's fiduciary governance structure to work. Among the most important and closely scrutinized tasks of 401(k) plan fiduciaries are selecting and monitoring plan investment options and plan service providers. Over the years, as 401(k) plans have grown in size and number, so has the complexity of service provider fee arrangements. One of the main allegations in most 401(k) plan fee cases is that plan fiduciaries were not aware of the indirect compensation that plan service providers were receiving in connection with plan investments. While some types of fees have not traditionally been the subject of rigorous disclosure, a more likely scenario is one in which plan fiduciaries understand the overall level of compensation for both investments and plan recordkeeping services, but may not have documented all of the fee components or the way compensation is allocated among the plan's various providers. Many of the filed 401(k) fee cases attempt to hold plan fiduciaries accountable for collecting (and disclosing to participants) very detailed and specific fee information for each service provider.

In addition to documenting an understanding of service provider and investment fees at the outset of a relationship, plan fiduciaries should monitor fees over time, including taking into account how changes in the plan (e.g., growth of assets) affect fees. For example, many plans offer investment options that are structured as mutual funds (as opposed to collective trust funds or accounts managed by an investment manager exclusively for the plan). Many mutual funds offer a variety of "share classes." While each share class has the same management fee, certain share classes (often referred to as "institutional" share classes) pass a lower level of expenses along to their investors. Many mutual funds require a certain threshold level of investment for entry into these lower cost share classes. As plan assets grow over time, the plan may become eligible for a lower cost share class. By keeping informed about the interaction between plan size and fees, plan fiduciaries can avoid allegations that plan participants have "overpaid" for an investment.

In addition to the fee litigation, the Department of Labor, the federal agency responsible for the regulation of ERISA plans, is in the process of imposing additional requirements on plan fiduciaries to obtain information about fees and expenses associated with the plan's investment options. The Department is also about to propose that plan fiduciaries be required to disclose more information to plan participants about fees and expenses. Finally, several bills have been introduced in Congress addressing 401(k) fees and expenses. Thus, it is quite likely that plan fiduciaries will have new reporting, monitoring, and disclosure obligations that become effective in the near future. Plan

fiduciaries who stay informed about these developments will be in a position to implement compliance strategies and avoid litigation.

Avoiding the Next Wave of 401(k) Litigation

The legal standards under which plan fiduciaries act are influenced by changes in the law, by regulatory developments and, increasingly, by the types of lawsuits that are filed and the responses of courts to new legal theories. Strengthening a plan's fiduciary governance structure, effectively dealing with company stock as a plan investment option, and monitoring plan fees are practices that have been revisited and refined in response to the current legal environment. Yet they are also practices that stem from the fundamental requirements imposed by ERISA. As legal theories evolve, companies offering 401(k) plans can stay ahead of the litigation curve by periodically reviewing the plan's "fiduciary fundamentals" and by keeping abreast of litigation trends.

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