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Port acknowledges the assistance of Scott Pritchard, managing director of Advisors Access in Atlanta, for his helpful comments on this article.

Navigate the minefield of fiduciary liability as a 401(k) plan sponsor

ROBERT C. PORT

THE MEDIA regularly carries stories of the struggles faced by those trying to save for a secure retirement. Employers are rapidly shifting away from defined benefit plans, in which employees were assured a certain level of retirement benefits based on years of service, in favor of defined contribution plans, such as 401(k) plans, in which an employee's retirement income will be derived from the accumulated contributions made to their account. Many defined contribution plans are self-directed, meaning it is the employee who selects the investments for the account, usually from options selected by the employer.

Realistically, however, many Americans lack the discipline to regularly and systematically save for retirement. Even those who do save and plan for retirement often have no meaningful understanding of how to manage their investments. In addition, investors are faced with an often volatile stock market, lack of transparency on the fees and costs to which their retirement dollars are being subjected and poor investment management and advice by supposed Wall Street experts. Efforts to address some of these systemic issues are often met by vigorous resistance by the financial industry - witness the continuing failure to implement regulations requiring that a uniform fiduciary standard apply to all financial professionals who provide personalized investment advice.

One small victory for retirement savers did occur, however, in July 2012, when the Department of Labor (DOL) issued its final rules under ERISA §408(b)(2) requiring that any service provider (i.e., insurance companies, investment firms) for retirement plans covered by ERISA (defined benefit, profit sharing, 401(k) and some 403(b) plans, but not IRAs, Simple IRAs, SEPs, or 403(b) plans) provide written disclosures about the services provided to the plan, the direct costs of those services (those paid by the plan) and indirect costs (those paid by any source other than the plan or the plan sponsor). Those disclosures are provided to the plan sponsor (the employer) who in turn shares it with plan beneficiaries (employees).

The rule also required that plan beneficiaries be provided with investment-related information in a chart or similar format designed to facilitate a comparison of each investment option available under the plan. The information to be provided includes (i) performance data for one-, five-, and 10-year periods; (ii) benchmark information for an appropriate market index over one-, five-, and 10-year periods; and (iii) fee and expense information, expressed as both a percentage of assets and as a dollar amount for each $1,000 invested.

This rule is a necessary complement to Section 404(a)(1) of ERISA, which requires that when plan fiduciaries (the employer, the plan administrator, and plan trustee) select and thereafter monitor service providers and the plan's investments, the plan fiduciaries act prudently and solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan.

The worthy goal of the DOL regulations was to provide plan fiduciaries with information necessary to make informed decisions on whether the service provider's compensation is reasonable, to identify any conflicts of interest that may have an impact on the ability of the service provider to act in the best interests of the plan, and to provide plan participants with the information to make better informed decisions for the management of their individual accounts.

Disclosure is great—then what?

Fulsome disclosure of the service provider's services, fees, and the extent of their fiduciary status is laudable—as Justice Louis Brandeis famously said, "sunlight is said to be the best of disinfectants." But unless plan fiduciaries have or secure the knowledge to make meaningful use of these disclosures, the interests of those whose interests they are charged with protect-

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ing—the employee participants in the plan—might suffer.

The reality is that the vast majority of 401(k) plans are offered by small employers, who may have no meaningful understanding of the fiduciary responsibilities they and their plan administrator have taken on by offering the plan. Unless a 401(k) is administered by a firm or individual independently obligated to act as a fiduciary (those firms and individuals subject to the Investment Advisor's Act or 1940), or administered for the employer by someone who has the interest, expertise and knowledge of the fundamentals of investing, this information will likely be filed away, after cursory review, in whatever folder or file contains the rest of the employer's plan documents. After all, the employer has a business to run, and is not running an investment advisory or consulting firm.

Litigation risk

Those charged under ERISA with having fiduciary responsibilities respecting the 401(k) should have the expertise and skill set to independently determine, both at the initial selection of the plan, and in periodic subsequent reviews, whether the plan provider's services, fees, and investment offerings are reasonable and appropriate for the plan and its beneficiaries.

Yet too often in selecting a plan provider, there is not a rigorous evaluation of competing providers' offerings, with an eye toward what is best for the plan beneficiaries. Instead, the service provider may be selected based on a relationship with a golfing or tennis acquaintance who is in, or knows someone in, the insurance or brokerage business. No thought or effort is given to investigating other service provider options.

Even with the DOL mandatory disclosures, what the employer and plan administrator do with those disclosures is critical. Do they know how to evaluate the performance data and benchmark information? Are they familiar with the teachings of Modern Portfolio Theory? Can they evaluate whether the investment selections offered by the proposed plan provider will allow participants to adequately diversify their retirement holdings? Do they know how to evaluate whether the fees and costs of a particular plan are reasonable and appropriate?

It is no defense to a claim of breach of fiduciary duty that the employer or its plan administrators were acting in good faith but did not know that they were required to seek the optimum plan for their particular needs. A "pure heart and an empty head" is no defense to a claim of fiduciary breach.

The failure to fully execute the fiduciary duties ERISA imposes upon 401(k) plan employers and administrators can lead to significant liability exposure. Even a relatively small employer selecting a service provider who charges only 0.5 percent more in fees than is reasonable and appropriate will, over a number of years, deprive employees of hundreds of thousands of dollars that would have otherwise accumulated in their retirement accounts. For larger employers, the range of potential damage to employees can be in the tens or hundreds of millions of dollars.

Recent cases illustrate these risks. Following a bench trial, an employer and its asset management firm were ordered to pay nearly $37 million for maintaining a plan that imposed excessive fees upon plan participants. *Tussey v. ABB Inc.*, 2012 U.S. Dist. LEXIS 45240 (W.D. Mo. Mar. 31, 2012), appeal pending, Nos. 12-2056; 12-2060; 12-3794; 12-3875 (8th Cir.). International Paper recently settled claims regarding its 401(k) for $30 million, *Beesley v. International Paper Co.*, No: 3:06-cv-703-DRH-SCW (S.D. Ill.), and CIGNA and Prudential agreed to pay $35 million to settle excessive fee claims regarding CIGNA's in-house 401(k) plan, *Nolte v. Cigna Corp.*, Case No: 2:07-CV-02046-HAB-DGB (C.D. Il.). Also, a recently filed federal lawsuit accuses Fidelity Investments of putting its costly proprietary funds into their own employees' profit-sharing plan, even though cheaper options were available. *Bilewicz v. FMR LLC*, Case No: 13-10636 (D. Mass.).

The allegations in these cases provide insight into the multitude of ways in which a plan can expose employers, plan administrators, and plan service providers to liability for fiduciary breaches damaging to plan participants: paying excessive administrative fees; paying excessive investment management fees; delaying the investment of employee contributions and diverting the interest that accrued thereon to the employer's coffers; unreasonably requiring plan beneficiaries to purchase company stock; failing to negotiate rebates from the plan's service provider; failing to monitor the fees and expenses paid by the plan; and selecting investments that had higher expenses than other similar and suitable investments with lower expenses.

Suggested best practices

Selecting a suitable and appropriate 401(k) plan, and its administration thereafter, are not simply annoying administrative tasks to be delegated to any staff person or senior executive who might appear to have some financial acumen or business sense. This is no place for amateurs. Plan participants' retirement funds are too important to be treated carelessly, or to be blindly placed in the hands of the first service provider that comes along.

Unless an employer and their plan administrator have the specific knowledge and skills to understand and compare the offerings and costs of competing service providers, and thereafter periodically monitor the reasonableness of the service provider selected, it is prudent for them to seek out the involvement of an independent, conflict-free adviser to review and make those recommendations. Preferred are advisory firms and individuals registered under the Investment Advisor's Act of 1940. These Registered Investment Advisors (RIAs) are required to act as fiduciaries in their dealings with the employer/plan sponsor and plan administrator. An RIA would advise as to the selection of a plan which is in the best interests of the plan's participants. As an independent fiduciary who is not associated with any service providers, an RIA will not be tempted, as often happens when a stock broker or insurance agent is involved, to recommend the use of their own firm's plan, or a plan offered by a related entity, for which the broker or agent may well receive a referral fee or other compensation.

An independent, conflict-free adviser working solely for the employer's interests can undertake the following types of analysis: (i) evaluate and benchmark the administrative costs and other costs of a plan relative to its peers; (ii) decipher the sometimes confusing and opaque service provider disclosures to determine whether any other fees are being paid to the provider (such as "revenue-sharing" arrangements, where a service provider might receive payments from the firms with whom beneficiaries' funds are invested); (iii) evaluate whether a "bundled" plan covering all investment, administration, and recordkeeping requirements, is preferable to an "unbundled" plan in which separate companies provide those services; (iv) assess the reasonableness of any proposed "wrap fees," which are fees charged as a percentage of assets for recordkeeping and administration; (v) evaluate the investment options offered by a plan to determine whether they are cost effective and can provide a suitable array of diversification and asset allocation options to plan participants; and (vi) determine the extent to which a service provider is expressly taking on fiduciary duties to select and monitor the investment options available under the plan, or merely offering a limited fiduciary role of ensuring the "best execution" of any investment transactions.

A non-conflicted investment adviser also can be of significant value to plan participants. The vast majority of individual investors are notoriously inept in managing their own investments. They buy when the market is high and sell in panic when the market falls, buy investments paying high dividends or interest without realizing that high yield means high risk, chase recent high-flying stocks and mutual funds highlighted by the media, fail to diversify and engage in other wealth-destroying behaviors.

Further, there is often significant misunderstanding among plan participants about their 401(k) plan—many believe it is offered for "free" or that the costs are paid by the employer, and thus have no sensitivity to the reality that plan fees and expenses can materially affect performance, and ultimately, the wealth they accumulate for retirement. Thus, there is an opportunity for the employer to have a "teachable moment"—an employee may (but is not required to) offer plan beneficiaries the opportunity to periodically consult with an independent RIA. With the guidance and counsel of an adviser who is not paid on commission, a participant is more likely select to prudent, reasonable and suitable investment choices. Such an adviser can provide the employer with another level of fiduciary oversight and input regarding the suitability and appropriateness of the plan.

Retirement assets are too important to be left to haphazard administration and management, either by the employer sponsor in selecting the plan or by employee participants self-directing their retirement savings. Employers without the necessary expertise to evaluate the information now required to be disclosed about a plan's investment choices, fees, expenses and other critical information should seek the advice of a qualified, independent and conflict-free adviser to help select their plan and periodically monitor it thereafter. Doing anything less may well be a breach of the employers' ERISA fiduciary duties.