

Best practices for preventing 401(k) plan lawsuits

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There has been a big increase in lawsuits against 401(k) plan fiduciaries in recent years, and some law firms specialize in suing 401(k) plan fiduciaries on behalf of aggrieved plan participants.

The subprime mortgage crisis will only accelerate this trend by causing losses for many bond funds available as plan investment options.

Fiduciary bonding required by ERISA does not protect against ordinary litigation losses.

Fiduciary liability insurance may be purchased to protect against legal judgments, with the limits and exclusions available in the market, but obviously, it is better for plan sponsors to avoid being drawn into lawsuits in the first place than to rely on insurance coverage.

While it is impossible to eliminate the risk of being sued, following several steps should help 401(k) plan fiduciaries reduce their risk of becoming a lawsuit target.

Make your investment program more litigation-proof

Use ERISA's safe harbors.

If you select available investments prudently and in accordance with regulations, the Section 404(c) safe harbor makes participants responsible for their investment choices.

In addition, a safe harbor default investment makes plan participants responsible, even if they fail to file elections.

Make sure low-fee index funds and funds from more than one fund family are part of the menu available to participants.

To prevent lawsuits over excessive or hidden fees, disclose the direct and indirect fees associated with the investment choices.

Review fund performance periodically and consider replacing underperforming funds.

Consider an investment education program for participants, since they are more likely to sue if they have losses. The Pension Protection Act and other guidance set out a roadmap of how to do this without assuming fiduciary responsibility.

If your plan permits investment in company stock, you are much more likely to be sued when unfavorable corporate news causes the price to go down.

There have been a rash of "stock drop" cases since Enron went bankrupt.

You may get some protection by providing for a permanent stock fund in your plan document.

You also may want to make company stock a completely elective investment for all purposes.

Give participants required diversification notices and consider limiting the percentage of a participant's account that may be invested in company stock.

The Pension Protection Act's diversification rules permit such limits only when company stock becomes 10% of the account balance.

If your business is going through hard times, consider retaining an independent fiduciary to make decisions about whether to keep company stock as an investment option.

Review plan operations and communications

One of the most common reasons for participant lawsuits is inconsistency between the benefits described in the plan's summary plan description or other employee communications and the plan text.

Most summary plan descriptions contain disclaimers stating that the plan text governs in the case of conflict.

However, many courts will not recognize those disclaimers and will award greater benefits than were intended if they appear to have been promised in the summary plan description.

All communications should describe any important limits or restrictions on benefits.

Discrepancies between plan documents and operations also can lead to litigation, as well as qualification and audit problems with the Internal Revenue Service.

For example, if the plan states that new contribution elections will be effective on the first of each month, but your administrator is not implementing them until the middle of the month, some participants will be missing out on contributions, including any related matching contributions and additional earnings.

They may try to sue for these lost contributions and earnings.

Establish good procedures and written records

In court, fiduciary decisions are not reviewed with 20/20 hindsight, but by a standard of whether the actions were prudent and appropriate at the time they occurred.

Document the care with which decisions are taken and the factors taken into consideration in detailed written minutes.

The Department of Labor has an ongoing project to review plan fee arrangements, and recently proposed regulations identify the information plan fiduciaries should obtain about indirect fees and possible conflicts of interests, such as when your plan trustee's fees are paid out of rebates of fees from particular mutual funds.

Fiduciaries are not required to hire the least expensive trustee, administrator or investment manager, or choose investment funds with the lowest fees.

However, they should make sure that they understand the fees involved and that the fees are reasonable in relation to the quality and level of services provided.

The Department of Labor has produced two useful guides for fiduciaries to better understand their obligations in this area.

They are available on the Department of Labor's Web site at:

- www.dol.gov/ebsa/pdf/401kfebm.pdf
- www.dol.gov/ebsa/publications/fiduciaryresponsibility.html

Consult advisors at the first sign of trouble

Lawsuits often begin with phone calls or letters from participants claiming benefits.

By now, all 401(k) plans should have so-called "Firestone language" granting the plan administrator the sole authority to interpret ambiguous plan provisions in order to get deference for those decisions when challenged in court.

Fiduciaries also should develop model claims and appeals denial letters and consult their lawyer about how to frame denials on contentious issues or those that may relate to broad classes of participants.

Your attorney may be aware of a favorable precedent that supports your decision.

Sometimes a well-crafted denial letter will lead to a dropped claim, but if it does not, at least you will have the best possible record if the participant files a lawsuit.