When 401(k)s Attack

Is your retirement fund benefit a ticking time bomb?

By Jack Garson

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Wall Street torched Main Street. Then consumer confidence crumbled and unemployment soared. Finally, the recession pummeled the top and bottom lines of most companies. If you're still in business, it probably hasn't been easy these past few years. Now, this. Business owners, your 401(k) plan may be a ticking time bomb.

The average business owner knows more about getting to the 10th level in Dungeons & Dragons than the dangers of a 401(k) plan. Admit it. You sign a stack of papers and voila! you've got a 401(k) plan. Most folks don't read a word. They just sign where the plastic "sign here" tags stick out. But this is another case of "you don't know what you don't know." What you don't know about 401(k) plans can sink your company and shred your net worth.

A recent court case brought this reality home. No lesser authority than the Supreme Court of the United States of America says you could have unlimited personal liability if one of your employees loses money in the 401(k) plan you so generously established. How does that grab you? I didn't like it one bit either.

In LaRue v. DeWolff, Boberg & Associates, an employee, James LaRue, sued his employer for losses he suffered in his individual 401(k) account. The company's 401(k) plan afforded LaRue a number of different investment options, as is common with many plans today. He alleged that the people administering the plan failed to follow his instructions to make a change in his investments, causing him losses of $150,000. LaRue lost at trial and in a subsequent appeal. Those courts relied on a 1985 Supreme Court case that limited claims to misdeeds that affected an entire 401(k) plan and not merely an individual account holder.

The Bad News

But the Supreme Court took on LaRue's case and, in a recent groundbreaking ruling, held that the plan administrators could be held personally liable for the losses sustained by an individual account holder. Some commentators announced that this ruling threw open the courtroom doors to a whole new world of liability and lawsuits. But this case just emphasizes the perils that abound in establishing and managing 401(k) plans.

Even before the LaRue case, companies were paying out billions of dollars each year in judgments or settlements related to 401(k) and other employee benefit plans. The companies making these payments reads like a “Who’s Who” of the business world: Royal/Dutch Shell: $90 million; Enron: $85 million; Global Crossing: $79 million; Lucent: $69 million; Williams Companies: $55 million; WorldCom: $51 million; Household International: $46.5 million; Dynegy: $30.75 million; AT&T: $29 million and the list goes on. In 2002 alone, the Department of Labor reported more than 10,000 new lawsuits alleging that companies violated their duties regarding employee benefit plans.

As a general matter, any company that adopts a 401(k) plan as well as the owners and officers responsible for making decisions about the plan, have special duties called fiduciary duties, to their employees who participate in the plan. These fiduciary duties include:

- A duty of loyalty to act in the best interests of plan participants and beneficiaries and avoid conflicts of interest and self-dealing.

- A duty of prudence, requiring them to act with the skill, care and diligence that a prudent person – an expert, not a lay person like you and me – would use in similar circumstances.

- A duty to diversify plan investments and, where a plan permits participants to direct investments, a duty to provide a prudent selection of investment offerings and to monitor participants’ prudence in utilizing those investment options.

- A duty to comply with the 401(k) plan documents and applicable laws.

All of these duties create potentially enormous liability. Liability can arise when the mutual funds in your 401(k) plan significantly underperforms other plans, your employees get bad investment choices or bad investment advice, the fees borne by plan participants are excessive or hidden, plan participants don’t receive sufficient information to make good investment decisions or where, as alleged in LaRue, plan administrators fail to follow a participant’s investment instructions. When any of this occurs, you may have to repay the plan or the affected employee for any resulting losses. The government can even assess penalties equal to 20 percent of the losses recovered.

The Good News

Yes, there is good news. You can avoid almost all of this liability with the right measures and the right team.

For example, companies with 401(k) plans have significant exposure related to the investment advice given to their employees. But under a relatively new law, the Pension Protection Act of 2006, your business can hire a special investment advisor, called a fiduciary advisor. If you do so and meet a number of related requirements, you are relieved of liability for the advice provided to your employees.

Likewise, there are numerous other measures to reduce the exposure related to your 401(k) plan:

- When you hire service providers, such as third-party plan administrators, to help you with your plan, make sure that they agree – in writing, of course – to follow all legal requirements and to indemnify you if they don't.

- Buy fiduciary liability insurance and make sure it covers your potential exposure.

- Monitor the plan administrators to ensure that they are meeting with your employees periodically to review investment selections, provide information and advice of plans procedures.

- Hire consultants to audit compliance of your plan with financial, accounting and legal requirements, such as effective plan design, comprehensive investment advice and appropriate cost containment.

- Obtain an evaluation of where your plan ranks in comparison to others – a low ranking can be a precursor to lawsuits.

401(k) plans aren't going away. Understand the risks, then reduce and even eliminate that exposure.

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