Neglecting The Plan That Will Get 401(k) Sponsors Living on The Edge

By Ary Rosenbaum, Esq.

When you don't take care of your teeth, they end up rotting. When you don't take care of your car, it stops running. When you don't take care of your finances, you end up going broke. So it's amazing how many 401(k) plan sponsors don't take care of their plan and they end up living on the edge, the edge of huge liability exposures from plan participants and/or the government. So this article is about how plan sponsors are living on the edge by not taking care of their 401(k) plan.

The Edge Is Real

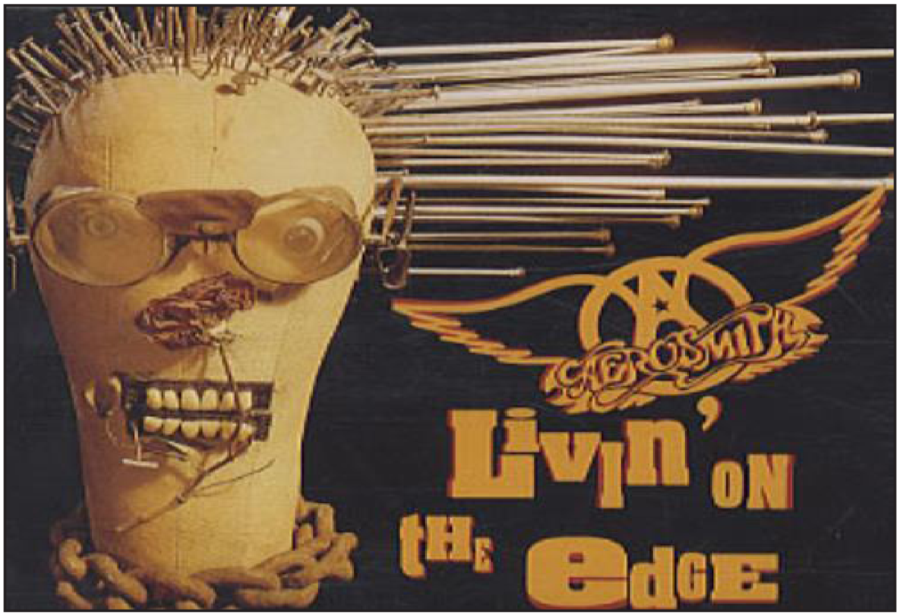
A plan sponsor is also a plan fiduciary and that requires the highest duty of care in law and equity. For years, I've heard that my warnings about the liability threats that small to medium sized 401(k) plans is the selling of fear but the litigation and government enforcement over the past few years has proven me correct. While it's larger 401(k) plans that get saddled with class action lawsuits, the fact is that smaller 401(k) plans are now being targeted as well. Participants of a $9 million 401(k) plan sued the plan sponsor before they eventually dropped the case and after the plan sponsor had to hire counsel. A class action lawsuit is just one threat that a plan sponsor can face. Besides a small lawsuit by plan participants, a plan sponsor can also fall of the edge from a complaint made by a plan participant to the Department of Labor (DOL). DOL and Internal Revenue Service investigations can occur by complaints or random plan audits and these are threats that effect plans of every size. A plan where the plan sponsor neglects their duties is easy picking for a government auditor to assess penalties and excise taxes. So a plan sponsor needs to take care of their retirement plan ton avoid pecuniary harm.

Not getting the proper insurance coverage

Every retirement plan that is covered under ERISA needs a fidelity bond to protect the plan's assets from theft by plan fiduciaries. This bond isn't optional and we know that because of the rules and because it's a question on Form 5500. Saying you don't have an ERISA bond covering plan assets is a good chance to get audited for any 401(k) plan sponsor. I knew a plan sponsor once that hired Bernie Madoff, who stole $3 million of their retirement plan assets. The lack of an ERISA bond didn't help them in trying to recover their losses. Fiduciary liability insurance is optional. Unlike an ERISA bond, fiduciary liability insurance is to protect plan fiduciaries from liability threats in exercising their duties. A plan sponsor gets sued; they can rely on the fiduciary liability insurance to soften the blow against high legal fees in defending a legal action. I know a well-known union that had $1 million in legal fees for a class action lawsuit filed against them that they actually won. The fiduciary liability policy had a $100,000 deductible so the union had the liability policy pay $900,000 of those legal fees. Litigation costs and any damages awarded to plan participants are too expensive to avoid buying fiduciary liability insurance.

Not reviewing the Plan on a consistent basis

Plan sponsors have a tendency to neglect their retirement plan after it's been implemented. The problem with this neglect is that any issues that come with a growing 401(k) plan only grow bigger. Administrative errors, high plan expenses, and inappropriate mutual share classes on the Plan's investment lineup are just some things that get ignored when the plan sponsor neglects to review their Plan on a consistent basis. What Plan sponsors fail to understand is that the buck stops with them That means that no matter who they hire as plan providers, they are going to ultimately be on the hook for any issues that affect their plan. Plan sponsors "own" the plan, so they are going to own any issues that affect it.



Not reviewing their fee disclosures

With the implementation of fee disclosure regulations, plan sponsors finally have the chance to get a breakdown of the fees that the Plan pays the plan providers. That eliminated the problem since plan sponsors have the fiduciary duty to pay reasonable fees even though they had no idea how much the plan was being charged. Even with these fee disclosures, most plan sponsors neglect them. A plan sponsor has a fiduciary duty to only pay reasonable plan expenses and how can they determine reasonableness if they don't benchmark the fees they are being charged against what's out there in the marketplace? Plan sponsors are living on the edge if they don't have a process in place to review the fees being charged to the Plan.

Not reviewing the work of plan providers

Too many times, a plan sponsor only discovers an issue with their Plan when they change plan providers and the new provider reviews the work of their predecessor. Too many times big errors in compliance testing and administration are discovered when a new third party administrator (TPA) is hired. How can a plan sponsor avoid this surprise? Have the work of their plan providers checked by an outside advisor such as an ERISA attorney like yours truly.

Not using a financial advisor

People can certainly handle their own investments, but they shouldn't handle the investments of other people if they don't have the background and licensing to do it. A plan sponsor has a fiduciary duty to care of the assets of their plan participants, so it's imperative that their plan has a financial advisor. Many plan sponsors may assume that no financial advisor is needed if their participant directs the investment of their account under ERISA §404(c). ERISA §404(c) is supposed to limit a plan sponsor's liability for losses sustained by a participant directing their own investment. The problem is that ERISA §404(c) requires a process in place such as a prudent selection of investment options as well as making sure that plan participants have enough information to make informed investment decisions The only person who can handle and help with the process is a financial advisor. A good financial advisor helps with formulating an investment policy statement to dictate the selection and replacement of plan investments as well as providing education to plan participants to help them make informed investment decisions.

Using a payroll provider as a TPA

This always gets me into trouble, but I think it's a mistake to hire the plan sponsor's payroll provider as TPA. For the most part, most payroll providers just treat TPA service as an ancillary service to their payroll business even though 401(k) administration has very little to do with payroll. Payroll provider TPAs make many mistakes in plan administration and don't have the knowledge to properly design 401(k) plans to maximize the contributions that a 401(k) plan sponsor can make to their highly compensated employees. Too many errors or an inefficient plan design will get plan sponsors living on the edge.

Picking providers on price

Would you pick your doctors on price? Then why do some plan sponsors pick plan providers just based on price? 401(k) plan sponsors don't have to pick the cheapest providers; they just have to pick providers that charge reasonable plan expenses. There are many cheaper providers that are good and there are many that are not so using price as the sole criteria for selecting plan providers is a bad idea.

An action plan to avoid living on the edge

A 401(k) plan sponsor can certainly avoid living on the edge by taking a few preventative steps. The 401(k) plan sponsor can hire the right plan providers and get the right amount of insurance coverage for fiduciary liability insurance. What is most important is hiring an independent ERISA attorney like me who can conduct a review of the plan, the plan document, and the plan providers to ensure that the plan is in compliance and maximizing its use for participation and contributions.

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