How A 401(k) Plan Sponsor Can Be A Mark For 401(k) Litigation

By Ary Rosenbaum, Esq.

I've always been a big fan of 1970's cinema and one forgotten classic is The Sting, starring Paul Newman, Robert Redford, and Robert Shaw. The title to the movie refers to the exact moment when the con artist finishes the "play" and takes the mark's money. Of course, any con requires a mark and a mark is that gullible person, "the sucker" for the con. When it comes to 401(k) plans, there are certain plan sponsors that are going to be the "mark" to get sued over their 401(k) plan. I'm not suggesting that 401(k) litigation is an actual con, but a plan sponsor who makes mistakes and ignores the plan is certainly a gullible person. This article lets 401(k) plan sponsors know what they can do to avoid being a mark or target for litigation.

Size no longer matters

When I first started my practice in 2010, I was trying to sell my services as an ERISA attorney to small to medium-sized 401(k) plans across the country (I still do, give me a call). I was told by a LinkedIn detractor that I was selling fear because there was never a small or medium-sized plan ever sued. While it's true that only larger 401(k) plans were being targeted for class action lawsuits, I reasoned that eventually small and medium-sized plans would be sued once litigation against larger plans was exhausted. Of course, class action lawsuits are only one form of litigation. I always reasoned that a terminated employee could use the 401(k) plan as blackmail to get a small settlement through threatening 401(k) litigation. Either way, the threat was real. Of course, since 2016, there have been at least a couple of lawsuits filed against small to medium-sized 401(k) plans. Regardless of whether this litigation has merit or not, it's irrelevant when a 401(k) plan sponsor has to go through the trouble of hiring an ERISA attorney to defend them especially when there is no fiduciary liability insurance to cover the costs. So being a smaller 401(k) plan isn't going to be a way to avoid being a mark for litigation.

Not having an IPS

When it comes to participant-directed 401(k) plans, it's all about a process and not a result. What does that mean? Participant-directed 401(k) plans are daily valued retirement plans where the participant directs their investment. ERISA §404(c) offers protection to plan sponsors for losses sustained by a participant as long as they follow a process. So it's not about participants not losing money, it's all about a prudent fiduciary process. It's about selecting a menu of investment options for participants and making sure that participants have enough information to make investment decisions. Selecting investment options requires a process and that process requires a criterion on what investments to choose and when it's a good idea to replace them. It's always a good idea to get those criteria down on paper. An investment policy statement (IPS) is a written policy that details what type of investments the plan sponsor should select and when they should be replaced. While an IPS isn't legally required, it's a necessary component to avoid being a mark.

Not following an IPS

What's worse than having an IPS? How about having an IPS and not following it? Again, as discussed, it's all about the process. Not following the process is indicative of a plan sponsor that isn't managing their 401(k) plan effectively. There was a recent class action lawsuit where the judge noted that the case wouldn't have been in court had the plan sponsor followed their IPS. Being a plan sponsor is being a plan fiduciary and as I say every week, a fiduciary duty requires the highest duty of care in law and equity. That duty required prudence and diligence. Laying out a policy that dictates how you select and replace plan investments is an important document detailing the fiduciary decision-making process. Not following the process is not prudent or diligent. If a plan sponsor has an IPS that they're not following, they are a mark or target for 401(k) litigation.

Not having the right share class

What do they say? You can't teach class? The problem with mutual funds in 401(k) plans is that there are just too many classes. When we talk about classes, we talk about shared classes. Mutual share classes are denoted by a letter and let's just say that it's one big alphabet soup. The different share classes have different expense ratios, some higher or lower usually dependent on the size of the 401(k) plan. Larger plans would have a share class with a lower expense ratio of the mutual fund they are offering while smaller plans would have a higher expense share class of that very same fund. The problem is when a larger plan has a more expensive share class of the mutual funds they are offering when a lower expense share class is available. For example, there has been rampant litigation against 401(k) plans where the plan sponsor has been held to violate their duty of prudence just because they had a high expense share class when a lower expense share class of the very same fund was available. So a 401(k) plan sponsor that is buying a mutual fund retail when they could have bought that same fund on wholesale is a mark or target for 401(k) litigation.

Picking revenue sharing paying funds

Revenue-sharing mutual funds are mutual funds that will forward something called a sub-ta fee to the third-party administrator (TPA) to help lower a 401(k) plan's administrative expense. This arrangement is something that has been done for a very long time but has been very controversial ever since fee disclosure regulations were implemented in 2012. The problem with using revenue-sharing paying funds is that not all mutual funds do it. Another problem is concern is that revenue-sharing funds don't reduce plan administrative expenses since it's highly likely that revenue-sharing paying funds are more expensive than funds that don't pay them. The other big problem is that many plan sponsors use the fact that a mutual fund pays revenue sharing as a major reason for the selection of their plan. Recent 401(k) litigations suggest that using revenue sharing as a reason for selecting a mutual fund for a 401(k) plan's investment lineup is a terrible idea. Revenue sharing can be a consideration for selecting a fund as long as it's in the IPS and as long as there are more prudent reasons why it's being selected. Selecting mutual funds just because they pay revenue sharing is a 401(k) plan sponsor that's a mark or target for 401(k) litigation.

Picking proprietary funds of the bundled provider

There is nothing wrong with using a bundled provider like a large mutual fund company that can offer recordkeeping, administration, and plan investments. Dealing directly with a mutual fund company can certainly have some cost advantages. The problem is that there has been an uptick in 401(k) litigation against plan sponsors who utilize the proprietary mutual funds of their bundled provider. For example, I can't forget the plan sponsor who was utilizing a bundled provider and all of the mutual funds offered under the plan were proprietary funds from that provider. That would be a problem because no mutual fund company is great at all different types and sectors of mutual funds. Using proprietary funds is like drinking alcohol, it should be done in moderation. Having a fund lineup dominated by proprietary funds may give people the impression that the plan sponsor isn't being prudent. A 401(k) plan sponsor blindly picking proprietary funds of their bundled provider can be a mark or target for 401(k) litigation.

Not reviewing plan expenses

With fee disclosure regulations, 401(k) plan sponsors are supposed to get a fee disclosure from their plan providers. It's not enough for a 401(k) plan sponsor to receive the disclosure; they need to review them. 401(k) plan sponsors have a fiduciary duty to pay reasonable plan expenses and the only way to do that is to benchmark those fees. 401(k) plan sponsors can use a benchmarking service or they can see what other plan providers are offering in the marketplace. Reasonableness is based on the fee being charged for the services being provided. So a plan sponsor doesn't have to pick the cheapest plan provider, just one that charges a reasonable fee. A 401(k) plan sponsor that doesn't benchmark their fees is possibly breaching their duty of paying reasonable plan expenses. A 401(k) plan sponsor that doesn't review their plan expenses is a mark or target for 401(k) litigation.

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